United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-6189

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PLS

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

BAUSCH & LOMB INCORPORATED and
DANIEL G. SCHUMAN,

Defendants-Appellees.

Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLANT

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PRELIMINARY STATEMENT

This is an appeal by the Securities and Exchange Commission from a final judgment, entered on October 1, 1976, by the Honorable Robert J. Ward, United States District Judge for the Southern District of New York, dismissing an action by the Commission against Bausch & Lomb Incorporated ("BOL") and Daniel G. Schuman, Chairman of BOL's Board of Directors (JA 191). 1/ The complaint sought an injunction and ancillary relief on the basis of violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5.

1/ "JA ___" refers to the pages of the joint appendix filed with this Court. "Ex ___" refers to the pages of the two volumes of exhibits filed with this Court.

In its complaint, the Commission alleged, and at trial the Commission proved, that material, nonpublic information about BOL was repeatedly divulged to a few securities analysts and other individuals by the top BOL corporate insider to the detriment of uninformed traders in the marketplace. The information was not disseminated to the media, or to the New York Stock Exchange (where BOL shares were listed); rather, BOL's co-Chief Executive Officer conveyed this material, nonpublic information to a few securities analysts. The reaction of a number of them to the information was swift and decisive -- immediate and substantial portfolio trades of BOL stock with unsuspecting investors.

Despite these facts, the district court ruled that no violation of law had been proved, but not because the traditional elements of a Commission Rule 10b-5 injunctive action had not been shown. Indeed, the lower court found all such elements present. Rather, the lower court found no violation because it believed that the Commission had failed to probe the mental processes and motives behind the BOL officer's repeated acts of selective disclosure -- that is, the Commission failed to prove that BOL's insider acted with <u>scienter</u>.

Because the misuse of inside information is one of the specific evils at which Section 10(b) and Rule 10b-5 were aimed; and because the rationale underlying the district court's decision could require the Commission in the future to forego protecting the marketplace from incipient or proposed deleterious conduct, if it cannot demonstrate <u>why</u> that conduct had occurred, or was about to occur, this appeal has been taken. The district court's opinion (JA 138-190) is formally reported at 420 F.Supp. 1226-1246.

QUESTIONS PRESENTED

The co-chief executive officer of a large corporation, whose stock is traded on the New York and Pacific Stock Exchanges, disclosed corporate information to several securities analysts and other persons during a several day period. This information was not public, and several of the recipients of it immediately traded large a number of shares of the corporation's stock. The district court dismissed the Commission's equitable suit for an injunction and to require the adoption of written procedures to prevent recurrences of disclosures of such inside information, _inter alia_, on the grounds that the Commission had not alleged or proved that the corporate official had acted with the "requisite scienter," which the court believed the decision of the Supreme Court in _Ernst & Ernst v. Hochfelder_ required, and that most of the information disclosed was not "material."

This case presents the following questions for review:

1. Whether the district court erred in holding that _scienter_ is a necessary element of a Commission action seeking equitable relief under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

2. Whether, assuming, _arguendo_, that _scienter_ is required in such an action, (a) the corporate official's intentional and knowing conduct directly met that requirement; or (b) his conduct met the requirement of _scienter_ because it was reckless.

3. Whether the district court erred, in determining that most of the disclosures made by the corporate officer were not material, when (a) the court, in determining materiality, failed to apply the standard of what a reasonable investor would consider important in making an investment decision; and (b) the court concluded that the following information, taken together,

was not material: a significant expected drop in first quarter earnings, a reduction in the company's estimated annual earnings; delays in the introduction of important new products; and lower than expected sales of major products.

4. Whether the district court erred (a) in holding that the injunction sought by the Commission was an "extraordinary" remedy, to be issued only in "extraordinary situations"; (b) in holding that the Commission should promulgate administrative regulations rather than exercise its statutory discretion to proceed by the institution of a civil injunctive action; and (c) in stating that the Commission, through the exercise of "administrative" powers it has with respect to members of the securities industry, could accomplish the same result sought to be achieved by the equitable relief requested in this case, where the industrial corporation involved is not subject to such administrative authority of the Commission.

STATEMENT OF THE CASE

Dramatis Personae

BOL is a publicly-held company with its principal place of business in Rochester, New York; its securities are listed on the New York Stock Exchange, and they are traded on both the New York and Pacific Stock Exchanges (JA 80, 85, 89).[2/] BOL manufactures and sells four major categories of products:

2/ The New York Stock Exchange Manual, a copy of which was maintained in BOL's files (Ex 136), sets forth certain obligations and responsibilities of companies whose stock is listed on the Exchange. Among those obligations is the duty to disclose, in a timely fashion, all information which might affect the market for the listed company's securities. The pertinent portions of the New York Stock Exchange Manual, including the procedures suggested as a minimum for the release of corporate news requiring immediate publicity, are set forth, *infra*, pp. 59-61, n. 102.

hydrophilic, or "soft" contact lenses, various opthamalic products, scientific instruments, and consumer products. BOL is regarded as a leader in the optical field (JA 82).

Daniel G. Schuman has been Chairman of the Board of Directors and co-Chief Executive Officer of BOL since May, 1971. Previously, and since 1967, he was BOL's Executive Vice-President for Finance and Administration and, in that capacity, he was BOL's principal liaison with the financial community, having primary responsibility for BOL's communications with securities analysts (JA 80-81, 195, 435).

In 1966, BOL acquired a patent license relating to hydrophilic contact lenses (JA 82), which provided significant advantages over conventional "hard" contact lenses, including easier adaptation by the wearer following initial fitting and greater wearing comfort (JA 82). In May, 1971, after expending substantial time, effort, and resources to develop, improve, and test the hydrophilic lens (JA 82-83), BOL began marketing such lenses throughout the United States under the trade name "Soflens."

BOL was the first and, until July, 1973, the only company to receive approval from the Food and Drug Administration to market hydrophilic lenses in this country (JA 82-23),[3/] and the introduction of Soflens had a significant impact on the market price of BOL's common stock (Ex 39, 43, 44, 46, 47, 51, 53, 55, 58, 308, 339, 344, 357). In addition, profits from Soflens sales

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3/ In March, 1971, BOL had received approval from the Food and Drug Administration to market its soft contact lenses (JA 82).

resulted in a substantial increase in BOL's earnings per share of common stock as early as the third and fourth quarters of 1971 (JA 83). 4/

Initially, Soflens had been sold to opthalmic practitioners (opthamologists, optometrists, and opticians) only in a fitting kit containing seventy-two lenses, together with necessary patient and practitioner accessories. The kit, which represented a practitioner's beginning inventory, contained a range of lenses which BOL believed necessary to enable a practitioner properly to fit lenses to individual patients. Practitioners could reorder any qualities of lenses or accessories desired (JA 83). When experience demonstrated that practitioners could function with a smaller initial inventory, BOL had made plans to introduce, in early 1972, a "minikit," consisting of thirty-eight lenses and accessories (JA 251-252). BOL had also planned to introduce, in early 1972, aphakic lenses, which were a type of hydrophilic lenses designed for post-cataract operation patients to compensate for lenses removed from the cornea of the eye (JA 252).

4/ BOL's earnings for 1970, 1971 (not including earnings from a 1971 acquisition or extraordinary income), and the first quarter of 1972 were:

	1970	1971	1972
First quarter	$ .36	$ .27	$.68
Second quarter	.43	.45	
Third quarter	.39	.61	
Fourth quarter	.35	1.02	
	$1.53	$2.35	

(JA 83).

Seventeen Days in March: A Tale of Selective Disclosures and Massive Selling Reaction

1. February 29 and March 1, 1972: The First Instance of Selective Disclosure; BOL Issues an Immediate Press Release to Explain an Analyst's Rumor Concerning the Halt in Shipments of Soflens.

Adverse publicity developed concerning the Soflens in late 1971 and early 1972. Articles in the press suggested that soft contact lenses could become a health threat to their users, that the Food and Drug Administration might make inquiries, and that competitors might enter the field (Ex 363, 374, 375, 376, 377, 378, 379, 388). In the midst of rumors about contamination of the Soflens, late in the afternoon of February 29, 1972, Donald Allen, Secretary and Vice President of BOL, received a telephone call from a securities analyst inquiring about a rumor that BOL had halted shipments of Soflens to practitioners. Allen confirmed the rumor for the analyst, informing him that a problem existed with the teflon washer which was used to seal Soflens shipping vials, and stating that BOL expected to resume Soflens shipments within a day or two. Allen then reported this conversation to Jack Harby, BOL's President, and suggested the issuance of a press release concerning the interruption in Soflens shipments. Harby agreed with the suggestion, and Allen prepared a draft release at home that evening (Ex 137-141).

The next morning, March 1, 1972, at approximately 8:40 a.m., E.S.T., Allen telephoned the defendant, Daniel Schuman, who was vacationing in Mexico, and read the proposed press release to him. Mr. Schuman suggested an addition to the release to indicate that the process of removing the teflon washer and resealing the Soflens shipping vial had been approved

by the Food and Drug Administration. While Eugene Stillman, BOL's Financial Vice-President, continued the telephone conversation with Mr. Schuman, Allen learned, as a result of a telephone call from a BOL shareholder, that the price of BOL stock had dropped approximately ten dollars on the previous day on the Pacific Stock Exchange. Allen conveyed this information to Mr. Schuman, who suggested that Allen contact Mr. Wick, the head of the New York Stock Exchange's stock list department. Following that suggestion, Allen had two telephone conversations with Mr. Wick, who advised that a press release be issued (JA 207-209; Ex 141-147).

That same day, prior to the opening of trading in BOL stock on the New York Stock Exchange, BOL issued a press release which stated both that Soflens shipments had been halted for several days due to a shipping vial problem and that shipments were scheduled to resume the next day (Ex 27, 147-148). Consistent with BOL's customary practice, the Dow Jones and Reuters news wire services were immediately called and read the text of the BOL release (Ex 148-149). 6/

5/ Although Soflens shipments in fact did not resume until March 10, 1972, nearly ten days later, BOL made no further public announcement to correct the information given in its March 1 release.

6/ The March 1, 1972, press release was issued almost simultaneously to Dow Jones and Reuters. That action was taken, in part, on the basis of BOL's Secretary's understanding of the requirements of the New York Stock Exchange Manual (Ex 148-150).

2. Two Weeks Later -- The Week of March 13, 1972: More Selective Disclosure of Nonpublic Corporate Information to Analysts and Other Individuals.

On Monday, March 13, 1972, when Daniel Schuman returned from his vacation, he learned that his secretary had tentatively scheduled, for later that week, a number of interviews with securities analysts who had requested to see him (JA 350-351). He agreed to keep the appointments as scheduled (JA 352). That evening, pursuant to Mr. Schuman's request, BOL's Controller provided him with a March 9, 1972, revised internal earnings forecast for BOL's first quarter of 1972 7/ of $.74 per share of common stock. 8/

A. March 15, 1972: Selective Disclosure Resumes.

On the afternoon of March 15, 1972, between 3:30 p.m. and 4:00 p.m., Mr. Schuman met with Byron Wien and Richard J. Clancy, two partners in the investment advisory firm of Brokaw, Schaenen, Wien, Clancy & Co. ("Brokaw"), for a previously scheduled interview at BOL's offices in Rochester. During the course of the interview, the parties generally discussed, among other things, the widespread adverse publicity concerning soft contact lenses which

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7/ BOL's first quarter ended on March 25, 1972 (Ex 25).

8/ On January 19, 1972, BOL previously had internally forecasted earnings per share of $1.04 for the first quarter of 1972 (Ex 17-18). Subsequently, on February 15, 1972, BOL reduced its internal earnings forecast to $.95 for the same period (Ex 21, 63). Mr. Schuman knew that the forecasted internal earnings figure had been reduced to $.95 prior to his departure for vacation on February 23, 1972 (JA 204). The March 9, 1972, internal earnings forecast revised downward BOL's previously projected income from sales of "seventy-two lenses kits" and accessories. More importantly, this forecast removed from projected first quarter earnings income from sales of the "minikit" and the "aphakic lenses," described, *supra*, p. 6, since those two products no longer were to be, as originally expected, introduced during BOL's first quarter of 1972 (Ex 22-23).

had been circulating in the financial press for the past few months, 9/ and its harmful impact on BOL. At that meeting, Mr. Schuman conveyed the following nonpublic corporate information about BOL to Wien and Clancy:

-- that an annual earnings estimate being used by financial analyst Lewis Sanders for BOL's common stock for 1972 of $5 per share was optimistic and that Sanders should be more conservative (Ex 71-72);

-- that an annual earnings estimate for BOL's common stock for 1972 of $3 per share was too low (Ex 88-89);

-- that the Soflens minikit would not be introduced in the first quarter of 1972 (JA 250);

-- that the aphakic lenses would not be introduced until the end of April or the beginning of May, 1972 (JA 248-249); 10/

-- that Soflens sales, which had flattened out, were being seriously hurt by adverse publicity and that BOL could no longer make the statement, as it previously had, that Soflens sales were increasing on a week-to-week basis (JA 242-244; Ex 73);

-- that the Soflen sales rate was less than one lens per practitioner per week (Ex 81-82); and

-- that BOL employees were engaged in the process of revising internal earnings estimates (Ex 72-73).

9/ As noted, supra, p. 7, during the preceding six months, numerous articles had questioned the safety and efficacy of soft contact lenses in light of reports that such lenses were easily susceptible to bacterial contamination. See Ex 363, 368-369, 374, 376, 388.

10/ Any delay in the introduction of the aphakic lenses was of vital importance for BOL's first quarter earnings, as BOL itself understood. Thus, for example, Jack Harby, President of BOL, informed one analyst that BOL's "earnings for the quarter depend importantly on the introduction and shipment of aphakic lenses" (JA 655). Similarly, BOL's Controller, Harry Hooley, stated that the removal of projected income from sales of the minikits and aphakic lenses would "very definitely" have an important effect on BOL's earnings per share (Ex 119). See discussion, infra, pp. 73 to 78.

None of the above-described information had been publicly released by BOL at that time (JA 426-427).

The interview had a decided impact on the two analysts to whom Mr. Schuman disclosed this nonpublic information: Wien concluded that Brokaw's entire position in BOL should be sold and Clancy was of the view that the firm's sizable holdings of BOL stock should be reduced by one-third (Ex 75-76, 82, 84). At a Brokaw partnership meeting early the next morning, March 16, 1972, after Wien and Clancy related the nonpublic information that had been divulged to them by Mr. Schuman, the Brokaw partners determined to liquidate the firm's entire position in BOL common stock immediately, (Ex 78,84), and sold approximately 72,000 shares that morning (JA 94).[11/]

B. The Morning of March 16, 1972: Selective Disclosure Continues.

On the morning of March 16, at approximately 9:00 a.m., Mr. Schuman met for two hours with David MacCallum, a securities analyst with the firm of Faulkner, Dawkins & Sullivan ("FDS"), for a previously scheduled interview in Mr. Schuman's Rochester office. The first hour of the two-hour interview was devoted principally to a discussion of various aspects of BOL's traditional business, and the remaining hour centered on Soflens. During the interview, part of which occurred during a ride to downtown Rochester, Mr. Schuman

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11/ Brokaw placed a sell order for approximately 72,000 shares of BOL common stock at about 9:45 a.m. on March 16, 1972. The order was executed at approximately 11:21 a.m. that morning at prices ranging from 129-3/4 to 133-1/4 per share (JA 94).

Brokaw, as well as Clancy and Wien, were named as defendants in this action. The two individuals consented to the entry of a permanent injunction against them, without admitting or denying the allegations of the complaint. The action was settled with respect to the firm by the entry of a stipulation of discontinuance (JA 81).

conveyed nonpublic information concerning BOL to MacCallum, as follows:

-- that BOL was internally revising its figures and replanning its year in order to obtain an appraisal with respect to what was happening to BOL (JA 257-258); and

-- that the minikit would not be shipped until around the end of March, 1972 (JA 259).

— that the aphakic lens had not been introduced as previously planned and announced (JA 259, 502);

-- in response to MacCallum's inquiry whether BOL had sold 500-600 Soflens kits during the first quarter, Mr. Schuman responded that the estimate was a good one (JA 262-265, 473-475, 504-509);

-- in response to MacCallum's inquiry whether it was appropriate to believe that there would be 15,000-18,000 Soflens fittings during the first quarter of 1972 - assuming that there had been 10,000 such fittings in the last quarter of 1971 - Mr. Schuman responded that the estimate was a good ball park figure (JA 473-475, 510-517); and

-- that Soflens sales had flattened and that Mr. Schuman was no longer able to make the statement that Soflens sales were increasing week-to-week (JA 259, 514-517, 473-475).

None of the above-described information had been publicly released by BOL at that time (JA 426-427).

MacCallum, who was dropped off in downtown Rochester, immediately called Derrick Hoitsma, the manager of the FDS trading department in New York City, pursuant to Hoitsma's request (JA 472). MacCallum informed Hoitsma, among other things, that, as a result of his meeting with Mr. Schuman, MacCallum was reducing his estimate of BOL's first quarter earnings from $.90 per share to $.60-$.70 per share, that he was reducing his earnings per share estimate for the year from $6 down to $4, and that he was withdrawing his "buy" recommendation on BOL stock (JA 467-468, 478, 518). Hoitsma, in turn, leaped up and flashed the news to the FDS

trading room by yelling out that MacCallum had reduced his earnings estimate to $.60-$.70 and that he was withdrawing his "buy" recommendation on BOL (Ex 211-212).[12/] Thereupon, at approximately 11:23 a.m. Hoitsma placed orders to sell and sold 2,320 shares of BOL stock in thirteen discretionary accounts under his control, including his own account (JA 94).

C. <u>The Afternoon of March 16, 1972: While Trading in BOL Stock Continues, Mr. Schuman Selectively Discloses BOL's Internal Earnings Estimate to Certain Analysts, Telephone Callers, and a Newspaper Columnist</u>

Upon his return to BOL's offices at approximately 2:00 p.m. that afternoon, Mr. Schuman was informed by BOL's President, Jack Harby, that the latter had received a telephone call at 11:30 that morning inquiring about a rumor to the effect that an FDS analyst had been given a $.60 earnings figure by Mr. Schuman (JA 92, 267-268). Upon hearing this news, Mr. Schuman testified "I instantly decided that I was going to go with a number" (JA 392) and "was going to release a number to the press" (JA 275). He then instructed his secretary to "[g]et Hooley and Stillman [BOL's financial officers] here right away," to get MacCallum's office on the telephone, but also first to usher into his office Gary Burkhead, a securities analyst employed by

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12/ MacCallum, Hoitsma, FDS, and FDS, Inc., were named as defendants in this action. FDS and FDS, Inc., consented to the entry of permanent injunctions without admitting or denying the allegations of the complaint. With respect to Messrs. MacCallum and Hoitsma, the action was settled by a stipulation of discontinuance when they undertook to abide by the terms of the injunction entered against their employer and agreed to the institution of an administrative proceeding by the Commission and also to a sanction of censure in that proceeding (JA 81). <u>See, David H. MacCallum and Derrick C. Hoitsma</u>, Securities Exchange Act Release No. 13210, 11 SEC Docket 1561 (January 27, 1977).

Smith, Barney & Co., who had been waiting for his previously scheduled interview with Mr. Schuman (JA 269).

Mr. Schuman's call to FDS was placed at 2:24 p.m. When MacCallum answered the telephone, Mr. Schuman related the rumor which he had heard, but MacCallum advised Mr. Schuman that the $.60 per share earnings figure was his own. Mr. Schuman, in turn, responded that MacCallum's estimate was low, and that $.70-$.80 was more like it (JA 92-93, 270-271). 13/

Harry Hooley, BOL's Controller, and Eugene Stillman, the Financial Vice-President, then arrived outside Mr. Schuman's office. After concluding his telephone conversation with MacCallum, Mr. Schuman stepped out of his office and informed Hooley and Stillman that he intended to release a first quarter earnings estimate of $.70-$.80 per share. They indicated that they felt more comfortable with a $.65-$.75 estimate. After receiving the Hooley-Stillman estimate, Mr. Schuman placed a second call to MacCallum at FDS, and informed him that BOL's internal, and as yet still nonpublic, first quarter earnings estimate was $.65-$.75 per share (JA 93, 274-276).

Rather than preparing a press release to advise the trading public of what he had just selectively disclosed to MacCallum (and Burkhead, who was present in his office), Mr. Schuman thereafter called Dan Dorfman, a <u>Wall Street Journal</u> columnist (JA 93, 276). At the trial, Mr. Schuman attempted to explain his reason for calling Dorfman rather than issuing a release — namely, he believed he did not have "the time or the luxury to go through

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13/ Gary Burkhead was present in Mr. Schuman's office at the time, and overheard Mr. Schuman's entire conversation (JA 269-270, 276-277).

that whole process" of issuing a press release (JA 281). Mr. Schuman testified that Dorfman "hopped all over" him as to how he could have given an earnings estimate to the FDS analyst. In response, Mr. Schuman related to Dorfman the foregoing sequence of events, but had to repeat the story several times because Dorfman "didn't seem to be focusing on me" (JA 277-278).

Despite his desire to use Dorfman as a substitute for a widely-disseminated press release, Mr. Schuman quickly realized from his conversation with Dorfman that he lacked any assurance that the new BOL earnings estimate would in fact appear in print the next day. Indeed, Mr. Schuman testified:

> "I got a clear impression that he [Dorfman] had already written a story which related to the rumor and what I was now telling him meant he had to change it, and I wasn't sure how he was going to change it. I was concerned about it and I was trying to, in a sense, get some information out of him, some feeling from him as to just what he was going to do.
>
> "But he was pretty non-responsive to me on that, and finally he kind of cut me off by saying, 'Well, I can't hold up my story any more,' or however he stated that, and he just said something like, 'You're a great guy and I love you'" (JA 278).

As Mr. Schuman testified, "I knew he [Dorfman] heard every damn word I said," but "I didn't feel that he was responding to me" (JA 279). And, although Mr. Schuman candidly admitted that "I guess I have got to say I am not sure I knew what he [Dorfman] was going to do with what I was telling him" (JA 279), BOL did not issue a press release that afternoon, it did not alert the appropriate officials of the New York Stock Exchange to the problem or seek their advice as to how to proceed, and it made no

attempts to disseminate BOL's earnings estimate to the public through the news media channels customarily employed by BOL. 14/

Quite the contrary, throughout the remainder of the afternoon, and while trading continued in BOL's stock, Mr. Schuman conveyed the still nonpublic $.65-$.75 earnings estimate to several other telephone callers (JA 282-286, 396-398). 15/ And, as Mr. Schuman testified at trial, Gary Burkhead, the Smith, Barney analyst, was present in Mr. Schuman's office during all of these telephone conversations, "heard everything that was said * * * that afternoon" (JA 281-282), and suggested to Mr. Schuman that he get out a press release (JA 662).

For the day (March 16), 348,000 shares of BOL changed hands on the New York Stock Exchange, accompanied by an $11.75 decline in the price of the stock. (Ex 19, 399).

14/ Donald Allen, Secretary and a Vice-President of BOL, stated that, in March, 1972, BOL's practice regarding the dissemination of important corporate information "was to release to Dow Jones and Reuters and to the local news media and to the New York Times" (Ex 148-153). In accordance with that practice, presumably, was BOL's prompt issuance of a press release on March 1, 1972, to clarify the rumor circulating in the market regarding the halting of shipments of Soflens, which Allen had confirmed to an analyst late in the afternoon of the previous day. See pp. 7-8, supra.

15/ It appears that one of the telephone calls during which Mr. Schuman released the earnings estimate occurred prior to the close of trading on the New York Stock Exchange. The majority of the other calls in which Mr. Schuman released the earnings estimate occurred prior to 5 p.m., E.S.T., while trading was continuing on the Pacific Stock Exchange (JA 396-398).

D. <u>March 17, 1972: The New York Stock Exchange Refuses to Open Trading in BOL's Stock Until BOL Issues a Press Release; BOL Promptly Issues Such a Press Release</u>.

On the morning of March 17, 1972, the <u>Wall Street Journal</u> carried Dorfman's article on BOL (Ex 19). Among other things, the Dorfman article reported that

> "a Faulkner Dawkins analyst visited [BOL] * * * yesterday and was told that first quarter earnings would be between 65 cents and 75 cents a share, up from the year-earlier adjusted 28 cents. And, according to reports, some Faulkner people relayed this information -- which hadn't yet been made public -- to outsiders. Daniel Schuman, Bausch & Lomb chairman, confirmed he had given the analyst the estimate, which is considerably below the $1 and $1-plus a share some analysts have been estimating."

Upon reading the Dorfman story, and following the previous day's spectacular decline in the price of BOL stock, an official of the New York Stock Exchange called BOL and spoke to Donald Allen, BOL's Vice-President and Secretary. The Stock Exchange representative expressed concern about the Dorfman article, and urged that BOL issue a press release before the stock opened for trading on the Exchange (Ex 171-172). Mr. Schuman was informed of the concern while he was at his dentist's office; when he arrived at BOL's offices, he telephoned the Stock Exchange to explain his conduct on the previous day (JA 286-287). Later that morning, the Exchange informed Mr. Schuman that BOL stock would not be opened for trading unless and until the company issued an appropriate press release (JA 288). Early that afternoon, at approximately 2:00 p.m., BOL issued a press release, confirming the reduced internal BOL estimate of first quarter earnings per share, acknowledging "the postponement of the introduction of the aphakic series of SOLFENS contact lenses for post cataract patients," advising "shipments

of the smaller size practitioner SOFLENS kits will not commence until April," and revealing that "reordering of SOFLENS lenses by the practitioners slowed from their earlier rate * * *." (Ex 20).

The Proceedings Below

On June 4, 1973, the Commission filed a complaint seeking an injunction and other equitable relief 16/ against eleven individuals and entities, including BOL and Schuman, alleging that the foregoing activities violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder (JA 5-12). 17/

On September 16, 1976, following a four-day trial on the merits, at which the above-outlined evidence was adduced, the district court issued its opinion (JA 138-190) and, subsequently, on September 30, 1976, issued a final judgment dismissing "with prejudice and on the merits" the Commission's action against BOL and Mr. Schuman (JA 191).

16/ In addition to an injunction prohibiting future violations of the federal securities laws, the Commission requested that defendants BOL and Schuman be ordered

> "to adopt, implement and maintain written procedures designated to assure their compliance with Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder insofar as that Section and Rule prohibit the private disclosure of inside information" (JA 175-176).

17/ Prior to the commencement of the trial, six of the defendants consented to the entry of permanent injunctions without admitting or denying the allegations in the complaint. In addition, a stipulation of discontinuance was entered as to one other defendant (JA 81). With respect to the two remaining defendants other than BOL and Mr. Schuman, the action was settled. See p. 13, n. 12, supra.

In its opinion, the district court stated:

> "For purposes of an SEC enforcement proceeding seeking injunctive relief, the elements of a Rule 10b-5 violation include disclosure of material nonpublic corporate information and a connection between this disclosure and the purchase or sale of a security. * * * The level of the defendants' culpability is also a concern" (JA 150) (citation omitted).

The district court examined each of these elements in light of the evidence presented by the Commission at trial and certain selected judicial precedents.

With respect to the element of materiality, the district court found, as the Commission had charged in its complaint, that on March 16, 1972, Mr. Schuman had released "an earnings estimate to MacCallum over the telephone * * *," and that Mr. Schuman's conversation with MacCallum

> "did constitute the disclosure of material, non-public corporate information. Obviously, an estimate of earnings is among the most material of all conceivable revelations" (JA 162-163).

The district court determined, however, that the divulgence by BOL's top official of the then nonpublic facts about, inter alia, (1) BOL's reduced internal annual per share earnings estimates; (2) the postponement of the important Soflens minikit; (3) the deferred introduction of BOL's aphakic lenses; and (4) the significant drop in Soflens sales, conveyed to a few securities analysts and telephone callers on March 15 and 16, 1972, was not material (JA 152-160).

With respect to the one earnings estimate it found to be material, the district court concluded that "no violation" of Rule 10b-5 had been

established [18/] because "the Commission [had] not proven that Schuman acted with the requisite scienter" (JA 173, emphasis supplied). In unequivocal terms, the district court read into the Supreme Court's recent decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), what the Court so painstakenly left out -- that "scienter must be pleaded and proved whether suit is brought by the SEC or by a private litigant" (JA 169). Compare 425 U.S. at 194, n. 12.

On the basis of these findings, the district court denied the Commission's application for a permanent injunction, stating that "the record before the Court does not warrant the grant of this extraordinary remedy" (JA 174, emphasis supplied), which "should be issued when * * * needed in extraordinary situations and should not be utilized generally in lieu of administrative regulations" (JA 175) (footnote omitted, emphasis supplied). Relying upon a copy of a memorandum entitled "Disclosure of Company Information," which "purport[ed] * * * to reduce to writing BOL's policies and procedures on this subject" (JA 176), a memorandum presented to the court by BOL's attorneys "[a]fter the trial of this action was concluded," the Court declined directly to resolve the Commission's request that the defendants be required, by court order, to adopt and implement written procedures designed to assure future compliance with Section 10(b) and Rule 10b-5, even though the court

18/ The district court admitted to "some doubt" whether Schuman's selective disclosure of the internal BOL earnings estimate occurred "in connection with" the purchase or sale of a security (JA 173), but opined that "the facts of this case seem to satisfy" that requirement of Rule 10b-5 (JA 166).

stated that "this may or may not satisfy the Commission's quest for written procedures" (ibid).

The district court also suggested that, rather than relying upon the equitable powers of the district courts, the Commission should exercise its "administrative" authority over industrial corporations to require the adoption of such procedures (ibid). To support this suggestion, the district court quoted from an opinion of this Court relating to the Commission's authority with respect to registered securities brokers or dealers (ibid.), 19/ but failed to take note of the fact that the Commission has no comparable "administrative" powers to require publicly-held industrial companies, such as BOL, to adopt procedures of this sort.

ARGUMENT

Introduction and Summary

The overriding public policy issue presented by this case is whether the Commission may continue effectively to deal with the selective dissemination of material inside information which is so injurious to fair dealing in the nation's securities markets. If, as the district court held, the Commission is powerless to put a halt to the giving of such inside information to a favored few, unless it can also show that the giver of the information acted with an evil purpose, the careful structure to keep the securities markets honest which this Court reaffirmed in the Texas

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19/ Securities and Exchange Commission v. Geon Industries, Inc., 531 F. 2d 39, 55 (C.A. 2, 1976).

Gulf Sulphur decision,[20/] and upon which other courts have built, will be seriously eroded. As we discuss, infra, pp. 32-33 , Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d), authorizes the Commission to seek an injunction to prevent future violations of that Act, and neither that section nor comparable sections contained in the other securities acts which this Commission administers imposes any requirement that the Commission allege or that the court find any motive or intent. This was so because the deleterious impact on investors is the same irrespective of the intent of the actor. Hence, the public should be protected from persons who, while lacking evil motives, engage in conduct as equally deleterious to the fairness and integrity of the national securities makets the Commission is obligated to preserve and maintain.

1. At the time of the filing of the Commission's complaint, this was a simple case. In light of the lower court's decision, it no longer appears to be. Yet, as the foregoing statement of the facts adduced at trial amply evidences, a top BOL corporate official knowingly and selectively disseminated[21/] material, inside information about BOL, its vital products, and its all-important earnings per share, to a small

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20/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (C.A. 2, 1968) (en banc), certiorari denied sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

21/ Dissemination is selective when in fact information is given to a limited number of persons, irrespective of whether such persons were sought out and tipped by the defendant or whether the defendant, as here, gave the information to those who asked for it. The distinction is irrelevant to the critical concern of this case, the impact of the information disclosed on the fairness of the trading markets.

group of analysts. The significance of the information thus disclosed was readily apparent to all concerned: it prompted established and sophisticated securities analysts to make and to encourage immediate and hefty trades of large amounts of BOL stock. As we noted, on March 16, following the analysts' receipt of this important, inside information, 348,000 shares of BOL stock were sold on the New York Stock Exchange, and the price of BOL stock declined almost $12.

2. The operative question on this appeal is whether the Commission is entitled to have the district court apply correct legal standards to the evidence presented in determining whether a violation of the federal securities laws has been proved, prior to determining whether the defendants are likely in the future to violate Section 10(b) and Rule 10b-5 and whether, in the exercise of its discretion, an injunction or other equitable relief should be issued.

At the outset, it should be noted that the Commission recognizes and in no way challenges the wisdom of this Court's rulings that, in a statutorily-authorized action for injunctive and other equitable relief, such as the case at bar, the district court is "vested with * * * wide discretion" 22/ whether to grant such relief. But, as this Court so often has held, in this context

> "[t]he critical question for a district court in deciding whether to issue a permanent injunction in view of past

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22/ Securities and Exchange Commission v. Universal Major Industries Corp., 546 F.2d 1044, 1048 (C.A. 2, 1976).

> violations is whether there is a reasonable likelihood that the wrong will be repeated." 23/

Indeed, "the commission of past illegal conduct is highly suggestive of the likelihood of future violations," 24/ such that an inference of future violations may be drawn. Although the district court's findings of basic fact are entitled to great weight and should not be set aside unless shown to be "clearly erroneous," 25/ this Court's review of the law applied by the district court to those factual findings is not subject to the clearly erroneous standard.

3. In the instant case, the district court denied the Commission's request for an injunction, not in the proper exercise of its discretion, but rather as a consequence of its application of incorrect legal principles. On this appeal, therefore, we primarily seek the aid of this Court in correcting those errors of law. 26/

23/ Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (C.A. 2, 1972), citing Securities and Exchange Commission v. Culpepper, 270 F.2d 240, 249 (C.A. 2, 1959), and United States v. W. T. Grant Co., 345 U.S. 629, 633 (1953). Accord, Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801, 807 (C.A. 2, 1975); Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1308 (C.A. 2, 1974).

24/ Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 807 and cases cited therein.

25/ See Rule 52(a), Federal Rules of Civil Procedure.

26/

> "Although a grant or denial of a preliminary injunction is within the discretion of the court to which it is addressed, where it is plain that the disposition was in substantial measure a result of the lower court's view of the law, which is inextricably bound up in the controversy, the appellate court can and should review such conclusions."

(footnote continued)

As we demonstrate below, among other things, the district court erred

— in holding that "scienter" is a necessary element of a Commission action seeking equitable relief under Section 10(b) of the Securities Exchange Act and Rule 10b-5, and, in any event, erred in concluding that the defendants had acted without scienter;

— by applying an erroneous standard of materiality to the facts present here and holding that significant nonpublic information concerning BOL's earnings, the introduction of important new products, and the sales of Soflens, which were disclosed by BOL's top corporate officer to certain selected individuals, was not material to investors;

— in holding that the equitable prophylactic relief sought by the Commission to ensure future compliance with the law is an "extra-ordinary" remedy;

— in holding that the Commission should promulgate admininstrative regulations regarding the scope of communications with securities analysts rather than exercise its statutory discretion to proceed by the institution of a civil injunctive action; and

— in announcing that the Commission, through the exercise of non-existent "administrative" powers, could accomplish the same result sought to be achieved by the equitable relief requested the form of written procedures designed to prevent future violations of Section 10(b) and Rule 10b-5 which were requested by the Commission.

These and other errors so tainted the lower court's consideration of the critical issue of whether there was a likelihood of future violations

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26/ (footnote continued)

Societe Comptroir De L'Indus v. Alexander's Department Stores, 299 F.2d 33, 36 (C.A. 2, 1962). See also, e.g., Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1106. See Securities and Exchange Commission v. First American Bank & Trust Co., 481 F.2d 673, 682 (C.A. 8, 1973); Douglas v. Beneficial Finance Co. of Anchorage, 469 F.2d 453, 454 (C.A. 9, 1972); Milsen Co. v. The Southland Corp., 454 F.2d 363, 369 (C.A. 7, 1971); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 613 (C.A. 2, 1962) (en banc) (dissent), reversed, 375 U.S. 180 (1963); Ring v. Spina, 148 F.2d 647, 650 (C.A. 2, 1945).

by the defendants as to prevent a fair exercise of that court's discretion on the question whether to grant the equitable relief sought by the Commission. Accordingly, we ask that this Court articulate the proper standards of law to be applied to the facts of this case, and to remand the case to the district court for reconsideration, in light of those correct legal standards, whether to grant the requested relief.[27/] In any event, and at a minimum, the Commission is entitled at least to an unequivocal finding that the law was violated where, as here, the facts will sustain such a holding.[28/]

4. The district court's opinion in this case evidences its misunderstanding of the correct legal principles which should have been applied. First, the court appears to have assumed, because of the language contained in prior cases decided by this Court involving egregious behavior, that if Mr. Schuman's behavior here were less egregious than the conduct in those cases, that fact alone disposed of this case. Thus, for example, the court below referred to this Court's opinion in Green v. Santa Fe Industries, Inc., 533 F. 2d 1283, 1287 (1976), reversed, ___ U.S. ___, 45 U.S.L.W. 4317 (March 23, 1977), where Judge Medina noted that "[s]ince

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27/ See Securities and Exchange Commission v. Geon Industries, Inc. supra, 531 F.2d at 50.

Of course, this Court could, if it deemed it appropriate in light of the compelling facts of this case, and the pervasive errors below, order the entry of an injunction and other equitable relief on its own. See, e.g., Securities and Exchange Commission v. Bowler, 427 F.2d 190 (C.A. 4, 1970); Mitchell v. Pidcock, 299 F.2d 281 (C.A. 5, 1962).

28/ See, e.g., United States v. Parke, Davis & Co., 365 U.S. 125 (1961).

the time to which the memory of man runneth not to the contrary the human animal has been full of cunning and guile;" the lower court commented that, in this case, Mr. Schuman "cannot fairly be described as a man 'full of cunning and guile'" (JA 142). The court below, in similar vein, stated that Mr. Schuman's "behavior is clearly distinguishable from Chasen's practice of intentional favoritism of a particular securities salesman in Lum's; [29/] Berman's 'driving cupidity and lack of principle and restraint,' in Shapiro, supra, at 1308; [30/] or any other of the forms of chicanery which are so characteristic of 10b-5 cases" (JA 170). The court below contrasted its finding with that of this Court in Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1101 (1972), where it was found that "appellants' 'violations were willful, blatant, and often completely outrageous'" (JA 174).

But, it is not necessary for a finding of violation against, or the imposition of liability upon, a defendant in a Commission equity suit for injunctive relief that the defendant be "full of cunning and guile," or be guilty of one or more forms of "chicanery," or engage in "completely outrageous" conduct. While, to be sure, the court below also alluded to more measured tests, the thrust of the lower court's opinion evidences that, to the court's mind, one cannot violate Section 10(b) and Rule 10b-5 by the mere intentional, selective disclosure by a company

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29/ Securities and Exchange Commission v. Lum's, Inc., 365 F.Supp. 1046 (S.D. N.Y., 1973).

30/ Securities and Exchange Commission v. Shapiro, supra, 494 F.2d at 1308.

official of material, inside information.[31/] We submit, however, that the law does prohibit that.

Secondly, the court stated: "The permissible scope of corporate communication with security analysts has yet to be authoritatively defined" (JA 175). But, this case hardly involves the outer limits of the scope of communications between a corporate officer and securities analysts. It does not present, as the lower court thought, the admittedly difficult problem of "a skilled analyst . . . extract[ing] pieces of a jigsaw puzzle which would not be significant to the ordinary investor but which the analyst could add to his own fund of knowledge and use toward constructing his ultimate judgment" (JA 149).[32/] As we discuss fully in our argument regarding the materiality of the repeated disclosures made in this case, _infra_, pages 66 to 83, the disclosures of which we complain, particularly when taken together, were meaningful in their own right to a reasonable investor.

What this case does involve is a much simpler question -- the selective disclosure of material, nonpublic information concerning BOL, a large publicly-held company, to several securities analysts and other individuals. These disclosures, coming as they did from BOL's chief corporate officer, gave the recipients of the information an unfair advantage over the company's uniformed existing and prospective shareholders, and enabled the recipients

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31/ We discuss this fully in Point II, _infra._, pp. 48 to 52.

32/ The court below also spoke of the controversy in this case in terms of analysts "culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports" (JA 147).

and others to whom they in turn selectively disclosed the information to profit from the ignorance of uninformed investors by selling BOL's securities on the basis of important and reliable inside information which was not then publicly-available. The evils inherent in this type of conduct, and the resulting inequality of access to information in the marketplace, are precisely the evils which Congress in enacting Section 10(b) of the Securities Exchange Act, the Commission in adopting Rule 10b-5 thereunder, and the courts in interpreting both the Section and the Rule over the years, have sought to eliminate to the fullest extent possible.

We do not here argue for perfect equality of knowledge by investors in in the nation's securities markets — that is an ideal which does not exist today, and which likely will never be attained. Nonetheless, Congress intended that investors be provided with equal access to information about the corporations in which they have entrusted, or are about to entrust, their savings. That is this case, and we respectfully submit that there is nothing novel, unique or atypical about the responsibility of corporate insiders in this situation. Nor is there any requirement, considering the harm that can be visited upon the trading markets, that the insider who disseminates nonpublic material corporate information be shown to have acted with "cunning and guile."

As the Commission itself has held in interpreting the reach of Rule 10b-5:

> "The objective of a fair market cannot be achieved when one of the parties to the transaction has inside information unavailable to the other. Few practices, short of manipulation, have as deleterious an effect on the investing public's confidence in corporate institutions and the securities markets as the selective disclosure

of and misuse of so called inside information, i.e., material, nonpublic information."

Faberge, Inc., Securities Exchange Act Release No. 10174, 1 SEC Docket No. 18, at 21, 23 (May 25, 1973). 33/

And this Court made clear in Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d 833, that the conduct involved in this case is well within the purview of Section 10(b) and Rule 10b-5:

> "Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."

Id. at 848. 34/ In that same case, this Court also recognized that

> "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks, — which market risks include, of course, the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital." 35/

Thus, in interpreting Section 10(b) and Rule 10b-5 as "encompass[ing] the infinite variety of devices that are alien to the 'climate of fair

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33/ See also, Securities and Exchange Commission v. Lum's, Inc., supra, 365 F. Supp. at 1057-1058 ; Investors Management Co., Inc., 44 S.E.C. 633 (1971); Cady, Roberts & Co., 40 S.E.C. 907 (1961).

34/ In its Texas Gulf Sulphur decision, this Court (401 F.2d at 849) similarly noted that

> "The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders."

See also, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (C.A. 2, 1974).

35/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 851-852 (citations omitted).

dealing,'" [36/] the courts have been "mindful that the overriding purpose of Section 10(b) and Rule 10b-5 was to protect the purity of the securities market * * *." [37/]

Given the salutary purposes for which Section 10(b) and Rule 10b-5 were adopted, together with judicial recognition that disclosure of material nonpublic corporate information on a selective basis violates the proscriptions of both the Section and Rule, we now turn to examine the conduct of Mr. Schuman and BOL, not to demonstrate that Mr. Schuman acted with moral turpitude, but rather to demonstrate that his actions had a deleterious impact on the securities markets and thus were in violation of the law.

I. THE DISTRICT COURT ERRED IN HOLDING THAT SCIENTER IS A NECESSARY ELEMENT OF A COMMISSION ACTION FOR EQUITABLE PROPHYLACTIC RELIEF UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 THEREUNDER.

Introduction

The concepts of "negligence" and "scienter" in an action such as this, to protect the public from future injury, are awkward where, as here, the defendants' conduct was knowing and intentional. These labels tend to obfuscate rather than illuminate analyses of the required standard of culpability. We show in Point II, *infra*, that Mr. Schuman's conduct can very well be analyzed as constituting *scienter*, both in terms of intentional acting

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36/ *Herpich* v. *Wallace*, 430 F.2d 792, 802 (C.A. 5, 1970).

37/ *Rochelle* v. *Marine Midland Grace Trust Co. of N.Y.*, 535 F.2d 523, 532 (C.A. 9, 1976). *See Blackie* v. *Barrack*, 524 F.2d 891, 907 (C.A. 9, 1975), *certiorari denied*, ___ U.S. ___, 97 S. Ct. 57 (1976) where the court stated:

> "The statute [10(b)] and rule [10b-5] are designed to foster an expectation that securities markets are free from fraud -- an expectation on which purchasers should be able to rely."

(infra., pages 46 to 52) and recklessness (infra., pages 52 to 66). We also show in Point I that negligence is a sufficient predicate for the imposition of injunctive relief. We deal at length with these concepts, however, because of the manner in which the lower court, and this and other courts, have discussed them.

Section 21(d) of the Securities Exchange Act, pursuant to which this injunctive action was brought, does not require the Commission to prove, or the court to find, that a past violation occurred in order for an injunction to issue. 38/ It is sufficient that the Commission make a "proper showing" that a person is engaged, or is about to engage in conduct which in fact violates the Act. Contrast Section 21(d) in this respect with Sections 15(b)(4) and (6) of the Act, 15 U.S.C. 78o(b)(4) and (6), which requires that the Commission, in order to impose a sanction upon a person in the securities industry, must find that such person "willfully" 39/ violated the law. Also compare Section 21(d) with Section 32 of the Act, 15 U.S.C. 78ff, which, similarly, requires that, in order to sustain a criminal conviction for violation of that Act's sections and rules, that the conduct be "willful." 40/

38/ This is not to say, however, that a finding by the court of a past violation is a meaningless exercise for, as we have noted supra, p. 24, this Court has often stated that an inference of future violations may be drawn from past violative conduct.

39/ As this and other courts have noted repeatedly, the requirement that the violation be "willful" imports proof no greater than the conduct was knowing, not that the actor knew it was unlawful. See, e.g., Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 181 (C.A. 2, 1976).

40/ As we show in more detail, infra, pp. 48 to 52, the courts have defined the requirement that criminal conduct be "willful" in a manner similar to the definition of that requirement for sanctioning a securities broker-dealer by the Commission -- that it is significant that the actor intended to do the act, and not that he also knew that he was violating the law.

But, here, the Commission is not seeking to put Mr. Schuman in jail or to terminate his livelihood. Rather, it is merely asking that his future conduct be subject to the shadow of contempt should he again in the future selectively give inside information.

A. This Court Has Firmly Established that a Cause of Action by the Commission Seeking Equitable Relief May Be Predicated upon Negligence.

As we have noted, the district court held that, in light of the recent Supreme Court decision in Ernst & Ernst v. Hochfelder, supra, 425 U.S. 185, "scienter must be pleaded and proved whether suit is brought by the SEC or a private litigant," and that "no violation" of Rule 10b-5 had been established in the instant case solely because "the Commission has not proven that Mr. Schuman acted with the requisite scienter" (JA 173, emphasis supplied). In so holding, the district court attempted to overrule well-established precedents of this Court and ignored the Supreme Court's decision in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), which was not affected by the Hochfelder decision.

Subsequent to the district court's decision, however, this Court "made it clear" that the law in this Circuit is that "in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter is not required" (emphasis supplied). Securities and Exchange

Commission v. Universal Major Industries, 546 F.2d 1044, 1047 (1976).[41/] Significantly, two of the decisions cited in Universal Major Industries as representing "the law of this Circuit," and, thus, as possessing continued vitality, are the very same decisions that the district court purported to overrule when it held that the Commission must plead and prove scienter in an injunctive action under Section 10(b) and Rule 10b-5.[42/] Moreover, the conceptual underpinnings of those two decisions, as well as the repeated and consistent decisions of this Court holding that negligence is the proper standard in Commission actions for equitable relief,[43/] can be

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41/ Universal Major Industries involved Section 5 of the Securities Act, whereas the instant action was brought pursuant to Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. But, that fact in no way detracts from this Court's explicit statement in Universal that negligence alone is a sufficient basis upon which to predicate a cause of action in a Commission suit for equitable relief. As this Court recognized in Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541, n. 12,(1973), it has "enunciated the negligence test principally in cases involving the anti-fraud provisions of the securities laws * * *." And, the vitality of the Spectrum decision was specifically reaffirmed by this Court in its Universal Major Industries decision, 546 F.2d at 1046-1047.

42/ Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d 801; Securities and Exchange Commission v. Spectrum, Ltd., supra, 489 F.2d 535.

43/ See Securities and Exchange Commission v. Everest Management Corp., 475 F.2d 1236, 1240 (C.A. 2, 1972); Securities and Exchange Commission v. North American Research & Development Corp., 424 F.2d 63 (C.A. 2, 1970); Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d 833; Cf. Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 180-181, n. 6 (C.A. 2, 1976) and Hanly v. Securities and Exchange Commission, 415 F.2d 589, 596 (C.A. 2, 1969). Other courts of appeals have also held that negligence is a sufficient predicate for a cause of action by the Commission. See, e.g., Securities and Exchange Commission v. Dolnick, 501 F.2d 1279, 1284 (C.A.

(footnote continued)

traced to the Supreme Court's teachings in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. 180.

In Capital Gains, the Supreme Court held that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages," id. at 193 44/ and that

> "To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute." Id. at 200.

It was to the Capital Gains case that the Supreme Court referred in Hochfelder when it noted that equitable actions under Rule 10b-5 might involve

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43/ (footnote continued)

7, 1974); Securities and Exchange Commission v. Pearson, 426 F.2d 1339 1343 (C.A. 10, 1970); Securities and Exchange Commission v. Van Horn, 371 F.2d 181, 186 (C.A. 7, 1966); Securities and Exchange Commission v. Geotek, [Current] CCH Fed. Sec. L. Rep. ¶97,756 (N.D. Cal., 1976). See, e.g. Securities and Exchange Commission v. Trans Jersey Bancorp., [Current] CCH Sec. L. Rep. 95,918 (D. N.J., 1976). Contra Securities and Exchange Commission v. Coffey, 493 F.2d 1304 (C.A. 6, 1974), certiorari denied, 420 U.S. 908 (1975); Securities and Exchange Commission v. American Realty Trust, [Current] CCH Fed. Sec. L. Rep. ¶ 95,913 (E.D. Va., 1977).

44/ See Haimoff, "Holmes Looks at Hochfelder and 10b-5," 32 Bus. Law. 147, 167 (1976), where the author, after quoting the Supreme Court's above-quoted statement in Capital Gains, concluded that:

> "It follows that Hochfelder should have no significance in cases involving 'insider transactions,' breaches of fiduciary duty or where the fraud charged sounds in equity. Scienter ought not to be an element -- the 'manipulative or deceptive device or contrivance,' condemned in section 10(b) of the 1934 Act, is found in the 'fraud' of the fiduciary."

different standards of conduct than actions for money damages. 45/ The district court's determination in the present case -- that scienter is a necessary element of a statutorily-authorized action by the Commission seeking equitable, prophylactic relief -- an issue which the Supreme Court in Hochfelder expressly declined to resolve, stands in derogation of the Supreme Court's teachings in Capital Gains, as well as the established precedents of this Court.

In addition, this Court's recent affirmation of the negligence standard in Commission actions for equitable relief in Universal Major Industries is the same result reached by the only other appellate court to consider this question since Hochfelder. In Securities and Exchange Commission v. World Radio Mission, Inc., 544 F. 2d 535 (C.A. 1, 1976), an action by the Commission seeking injunctive relief on the basis of alleged violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), the United

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45/ In Hochfelder, the Supreme Court said, noting the Capital Gains case, that,

> "[s]ince this case concerns an action for damages we * * * need not consider the question whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5."

Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 194, n. 12.

Notwithstanding the express intention of the Supreme Court to leave the question open, the court below in the instant case was of the view that the logic of the Supreme Court's reasoning compelled the imposition of a scienter requirement in a Commission injunctive action (JA 168). Such a lockstep approach cannot be squared with the Supreme Court's apparent unwillingness to decide that issue.

States Court of Appeals for the First Circuit rejected the defendants' contentions that they had not acted with intent to deceive and that, therefore, an injunction should not issue, stating:

> "From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendant's state of mind is irrelevant. If proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however much it may be a defense to a private suit for past actions, see Ernst & Ernst v. Hochfelder * * *, should make no difference. Cf. SEC v. Capital Gains Research Bureau, Inc., ante. Even those courts that correctly anticipated the Hochfelder outcome and required proof of scienter in private damage actions under rule 10b-5, see, e.g., Lanza v. Drexel & Co., 2 Cir., 1973, 479 F.2d 1277, have not considered intent relevant in SEC injunction actions, see, e.g., SEC v. Shapiro, 2 Cir., 1974, 494 F.2d 1301, 1308. An injunction is designed to protect the public against conduct, not to punish a state of mind. Hecht Co. v. Bowles, 1944, 321 U.S. 321, 329 * * *" (footnote omitted).

Id. at 540-541.

B. Application of a Negligence Standard in Commission Actions Under Section 10(b) and Rule 10b-5 Is Consistent With the Supreme Court's Decision in Ernst & Ernst v. Hochfelder and the Public Policy Considerations Underlying the Securities Exchange Act.

In Ernst & Ernst v. Hochfelder, supra, 425 U.S. 185, the Supreme Court had occasion to address the narrow issue "whether a private cause of action for damages will lie under §10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' -- intent to deceive, manipulate, or defraud."[46/]

46/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 193 (footnote omitted).

In determining the level of culpability required to be demonstrated in Commission actions, an issue which the Supreme Court has never decided, it would not be inappropriate for this Court to review and give weight to considerations of policy which militate in favor of continued application of the negligence standard. Cf. Santa Fe Industries, Inc. v. Green, supra, 45 U.S.L.W. at 4321-4322; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744, 749 (1975).

After reviewing the statutory language, portions of the legislative history of the Securities Exchange Act,[47/] the express civil liability provisions contained in the Securities Act and the Securities Exchange Act,[48/] and the administrative history of Rule 10b-5, the Supreme Court resolved the issue against the plaintiffs who, at most, had accused the defendant Ernst & Ernst of

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47/ In reviewing portions of the legislative history of the Securities Exchange Act in Hochfelder, the Supreme Court described a statement by Thomas C. Corcoran, a drafter of that Act, as "[t]he most relevant exposition of the provision that was to become §10(b)." 425 U.S. at 202. Mr. Corcoran remarked, among other things, that subsection (c) of Section 9 of H.R. 7852, which was a predecessor to Section 10(b) as enacted -- was "a catch-all clause to prevent manipulative devices." It should be noted, however, that Section 9(c) of H.R. 7852 was narrower than Section 10(b) in that 9(c) did not contain the term "deceptive". Recently in Santa Fe Industries, Inc. v. Green, supra, 45 U.S.L.W. at 4320, n. 13, the Supreme Court noted the "only specific reference to §10 in the Senate Report on the 1934 Act merely states that the section was aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. S. Rep. No. 792, 73d Cong., 2d Sess., 6 (1934)" (emphasis supplied).

48/ With respect to the Supreme Court's reliance on the express liability provisions to define the parameters of an implied action under Section 10(b), one commentator has observed that

> "[t]he inconclusiveness of the guidance provided by the legislative scheme in developing the contours for the implied private right of action under Section 10(b) was recognized by the Supreme Court in Blue Chip Stamps v. Manor Drug Stores wherein the Court dismissed the approach as being ill-suited for an action judicially created for which no actual intent may be attributed to Congress respecting its scope, 421 U.S. 723, 737 (1975)."

Cox, "Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws," 28 Hastings L. J. 569, 585 n. 77 (1977).

"inexcusable negligence"49/ in audits of a brokerage firm. But, the fact that the Supreme Court specifically declined to extend its holding to Commission actions seeking equitable relief suggests that the Court recognized the wisdom of the decisions of this Court and other United States Courts of Appeals which have established a lower standard of culpability -- negligence -- in statutorily authorized remedial actions designed to protect the public interest.50/

In addition, review of the Hochfelder decision indicates that the Supreme Court's rejection of a negligence standard in an implied private action for damages under Section 10(b) and Rule 10b-5 stemmed from the Court's concern that such a standard would seriously disrupt the statutory scheme embodied in the "carefully drawn express civil remedies" contained in the Securities Act and the Securities Exchange Act,51/ and "would significantly

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49/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 190, n. 5. In fact, examination of the factual setting underlying the Hochfelder decision demonstrates that the plaintiffs sought to hold Ernst & Ernst liable for negligent nonfeasance. Ernst & Ernst had not known of the conduct of the malefactor in that case. Indeed, the issue there was whether they were inexcusably negligent for not so knowing. In the case at bar, Mr. Schuman -- who was ostensibly the sole corporate officer responsible for BOL's relations with the financial community, but unbound by the restraints of any written policies or procedures regarding dissemination of corporate information -- engaged in a pattern of knowing conduct by intentionally disclosing material, nonpublic corporate information over a two-day period. The contrast between the inaction of the defendants in Hochfelder with the active, knowing conduct which gave rise to the instant action could not be greater.

50/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 194, n. 12.

51/ Id. at 200-201, 206-211. See Cox, "Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws," 28 Hastings L. J. 569, 583-586 (1977).

broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts,"[52/] with the consequent spectre of "liability in an indeterminate amount for an indeterminate time to an indeterminate class."[53/]

These concerns, of course, are inapplicable to actions by the Commission seeking equitable relief.[54/] For unlike the plaintiffs in Hochfelder, who sought monetary relief pursuant to an implied private right of action, the Commission instituted the case at bar pursuant to the express provisions of Section 21(d) of the Securities Exchange Act, which we have already discussed, -- a section which the Supreme Court in Hochfelder recognized as within the "arsenal of flexible enforcement powers" Congress provided to

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52/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 214, n. 33.

53/ Id. at 215, n. 33, quoting from Ultramares Corp. v. Touche, 255 N.Y. 170, 179-180, 174 N.E. 441, 444 (1931). See also, Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 833, 867 (Friendly, J., concurring).

54/ See, e.g., S. Rep. No. 94-75, 94th Cong., 1st Sess. at 77 (1975), where the Senate Committee on Housing, Banking and Urban Affairs recognized that

> "although both the Commission's suit for injunctive relief brought pursuant to express statutory authority and a private action for damages fall with the general category of civil (as distinct from criminal) proceedings, their objectives are really very different. Private actions for damages seek to adjudicate a private controversy between citizens; the Commission's action for civil injunction is a vital part of the Congressionally mandated scheme of law enforcement in the securities area."

the Commission. 55/ This distinction was forcefully noted by the Congress in 1975, when it adopted the Securities Acts Amendments of 1975, P.L. 84-29 (June 4, 1975):

> "Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to matters of damages, such as scienter, causation, and the extent of damages are elements not required to be demonstrated in a Commission injunctive action" (citation omitted, emphasis in original). 56/

In Commission actions "all that must be established is what the statute requires, without reference to proof of irreparable injury or the inadequacy of other remedies as in the usual suit for injunction." 57/ Indeed, it has long been settled in this Circuit that the standards which govern the issuance of an injunction authorized by statute are less strict than those applicable in private litigation, 58/ and that, in such cases, "the standards of the public interest and not the requirements of private interest measure the propriety and need for injunctive relief." 59/

55/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 195.

56/ See S. Rep. No. 94-75, supra, at 77.

57/ 3 L. Loss, Securities Regulation 1979 (2d ed., 1961) (footnotes omitted). Unlike private plaintiffs, if the Commission is denied relief, it has no remedy at law which it might choose to pursue.

58/ See, e.g., Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 807; Henderson v. Burd, 133 F.2d 515, 517 (C.A. 2, 1943); Securities and Exchange Commission v. Jones, 85 F.2d 17 (C.A. 2), certiorari denied, 299 U.S. 581 (1936).

59/ Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944), quoted with approval in Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d 808-809. Compare Rondeau v. Mosinee Paper Corp., supra, 422 U.S. 49, 57-59 (1975); Sonesta International Hotels Corp. v. Wellington Associates, 483 F.2d 247 (C.A. 2, 1973).

And, in actions seeking injunctions to protect the public from future violations of the federal securities laws, 60/ the Commission appears "not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws." 61/ Further, the injunctive relief sought by the Commission, which "can be of such great public benefit and do so little harm to legitimate activity," 62/ serves only as a "mild prophylactic" 63/ and simply requires the defendants to obey the securities laws in the future. 64/

60/ Securities and Exchange Commission v. World Radio Mission, Inc., supra, 544 F.2d at 541; Securities and Exchange Commission v. Trans Jersey Bancorp, supra, [Current] CCH Fed. Sec. L. Rep. ¶95,818; Securities and Exchange Commission v. F. L. Salomon, [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,335 (S.D. N.Y., 1975); Securities and Exchange Commission v. Golconda Mining Co., 327 F. Supp. 257 (S.D. N.Y., 1974). In Securities and Exchange Commission v. Petrofunds, 420 F. Supp. 958, 960, n. 6 (S.D. N.Y., 1976), appeal pending, No. 76-6184 (C.A. 2), Judge Weinfeld recently remarked:

> "Indeed, Congress recently has passed legislation significantly increasing the SEC's powers to regulate in the public interest see Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 * * *, and in doing so repeatedly emphasized the special status of the SEC as a protector of the public interest. S. Rep. 75, 94th Cong., 1st Sess. 1 passim."

61/ Securities and Exchange Commission v. Management Dynamics Inc., supra, 515 F.2d at 808.

62/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 868 (Friendly, J., concurring).

63/ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 193.

64/ See, Securities and Exchange Commission v. Graye, 156 F. Supp. 544, 547 (S.D. N.Y., 1957) (Kaufman, J.); accord, Mitchell v. Pidcock, supra, 299 F.2d 281, 287.

It "is designed to protect the public against conduct, not to punish a state of mind."[65/]

To summarize, it must be remembered that Commission injunctive actions, which are prospective in nature, seek relief designed to protect public investors from future violations of the federal securities laws -- violations which will have the same adverse impact on the public regardless of the defendants' state of mind or intentions. Private damage actions, on the other hand, are retrospective only, and are intended to provide monetary redress to the plaintiffs, and often others similarly situated, for past violative conduct. In light of these significant differences in the nature and purpose of Commission injunctive actions vis-a-vis private actions, a scienter requirement in Commission actions, and the resulting burden of proof such a standard would impose on the Commission, would only serve to hamper, not further, the broad remedial purposes of the federal securities laws.[66/] We respectfully submit that the negligence standard consistently applied by this Court in Commission injunctive actions is the only appropriate standard.

65/ Securities and Exchange Commission v. World Radio Mission, Inc., supra, 544 F.2d at 541.

66/ The Supreme Court has repeatedly emphasized that the federal securities laws should be construed broadly and flexibly to effectuate their remedial purposes. Santa Fe Industries, Inc., v. Green, supra, 45 U.S.L.W. at 4320-4321; Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 195.

II. EVEN ASSUMING, ARGUENDO, THAT SCIENTER IS A NECESSARY ELEMENT OF A COMMISSION ACTION FOR EQUITABLE RELIEF, THE EVIDENCE IN THE RECORD DEMONSTRATES THAT THE DEFENDANTS ACTED WITH THE REQUISITE CULPABILITY TO ESTABLISH VIOLATIONS OF SECTION 10(b) AND RULE 10b-5.

A. The Defendants' Duty and the Consequent Breach Thereof by Selective Disclosure of Material Nonpublic Corporate Information.

It is well settled that a corporation with publicly-traded securities, such as BOL, and its insiders, such as Mr. Schuman, owe a duty to the company's shareholders, as well as to the general investing public, to deal fairly with respect to the use of material, nonpublic corporate information in their possession.[67/] Such a duty demands not only that the corporation and its insiders not engage in securities trading on the basis of such information, but also that there be no selective dissemination of that information to others who might profit from using the information in securities transactions to the detriment of uniformed existing or prospective shareholders.[68/] That duty is, in part, based upon the precept that "[i]ntimacy demands restraint

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67/ See discussion, *supra*, pp. 29 to 31, and authorities cited, *supra*, at n. 33-35.

68/ See, *e.g.*, *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d 833, 848; *Cady, Roberts & Co.*, *supra*, 40 S.E.C. at 912. In *Cady Roberts*, the Commission articulated the test to determine those persons subject to a duty not to misuse material corporate information when it stated:

> "Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."

Id. at 912 (footnote omitted).

lest the uninformed be exploited" [69/] as well as the long-standing Congressional and judicial recognition of the fact that personal use, or selective disclosure, of material, nonpublic, corporate information destroys the parity of information available in the securities marketplace to the investing public and serves to undermine public confidence in our nation's capital markets. [70/]

Of particular significance to the case at bar is the rule that "one who may not himself trade in securities without disclosing information known to him may not pass that information to others for their use in securities transactions." [71/] A chief corporate officer, such as Mr. Schuman, "owe[s] a primary or fiduciary duty to the investing public not to abuse his position as insider in possession of confidential, corporate information by disclosing it to someone who might use it for personal purposes." [72/] In this regard, and for purposes of this appeal, it bears emphasis that

> "Disclosure by a corporate officer during the course of a number of phone calls does not under any circumstances constitute public disclosure. Public dissemination of information also cannot be accomplished by disclosure to or through a favored analyst or group of analysts. On the contrary, this facilitates improper use of nonpublic information." 73/

69/ Cady, Roberts & Co., supra, 40 S.E.C. at 912. There, the Commission described "the plight of the buying public" as being "wholly unprotected from the misuse of special information." Id. at 913.

70/ See discussion, supra, pp. 28-31.

71/ Merrill Lynch, Pierce, Fenner & Smith, 43 S.E.C. 933, 936 (1968). Investors Management Co., Inc., supra, 44 S.E.C. at 639; accord, Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (C.A. 2, 1972).

72/ Securities and Exchange Commission v. Lum's, Inc., supra, 365 F. Supp. at 1058. See also, Securities and Exchange Commission v. Geon Industries, Inc., supra, 531 F.2d at 47; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, supra, 495 F.2d at 237.

73/ Faberge, Inc., supra, 1 SEC Docket, No. 18, at 24 (emphasis supplied).

Thus, Mr. Schuman, as Chairman of the Board and co-Chief Executive Officer of BOL, was duty-bound not to disclose selectively the nonpublic, material information concerning BOL which he possessed by virtue of his corporate position. Yet he repeatedly breached that duty on March 15 and 16, 1972, when, in the course of personal interviews in his office, during an automobile ride to downtown Rochester, and in numerous telephone conversations, he disclosed to various securities analysts and other individuals nonpublic information concerning BOL, which as we demonstrate, infra, pages 66 to 83, was material to investors.

B. The Defendants Continuous Selective Disclosure of Material, Nonpublic Corporate Information Over a Seventeen-Day Period Demonstrates That They Acted With Scienter, as That Term Has Been Refined by the Courts.

As we have noted, the Supreme Court, in Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 194, n. 12, recently stated that scienter "refers to a mental state embracing intent to deceive, manipulate or defraud." Since the Hochfelder case involved simply allegations of negligent nonfeasance, the Supreme Court only had occasion to hold that "a private cause of action for damages will [not] lie under §10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'" 74/ and was not required to, and did not, resolve the question of what specific types of conduct involving culpability greater than mere negligence would satisfy the scienter standard and give rise to a private damage action under the Section and the Rule. More recently, however, in the context of another private damage action, the Supreme Court described its holding in Hochfelder as being that "a cause of action under

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74/ 425 U.S. at 193.

Rule 10b-5 does not lie for mere nelgigence * * *." Santa Fe Industries, Inc. v. Green, supra, 45 U.S.L.W. at 4320 (emphasis supplied).[75]

In addition, in Hochfelder, while resolving only the issues presented by the facts of that case, the Supreme Court recognized that it had not immutably and inflexibily defined scienter for purposes of all future Section 10(b) actions. That recognition is evidenced both by the Court's concession that "in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act," its determination to avoid the question "whether, in some circumstances, reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5," and, indeed, its definite reluctance to say whether any form of scienter was proper in an injunctive action under Rule 10b-5.[76] The Hochfelder opinion is interspersed with other indications to the same effect -- that the Court intended to allow for some flexibility in future interpretations of its scienter definition. For example, in its discussion of the language of Section 10(b), the Court remarked that the terms used therein "strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct;"[77] and in its discussion of legislative history, the Court concluded that "§10(b) was addressed to practices involving some element of scienter * * *."[78] Hence, the Hochfelder

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75/ Just as in Hochfelder, however, the Supreme Court in Santa Fe Industries did not have occasion to address the issue of the level of culpability required in Commission actions.

76/ Id. at 194, n. 12. As we have already noted, supra, p. 36, n. 45, the Court in Hochfelder likewise specifically avoided consideration of the question "whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5." Ibid.

77/ Id. at 199 (emphasis supplied).

78/ Id. at 201 (emphasis supplied).

decision, at best, serves only as an initial point from which an analysis of the level of the defendants' culpability may commence, and does not provide a definitive standard against which the defendants' conduct is to be measured. 79/ As a consequence, it is necessary to consider the Hochfelder scienter definition, as it has been refined into a practicable and meaningful standard by various courts, in order to gauge the defendants' conduct and their level of culpability. 80/ That exercise, as we discuss below, establishes that Daniel Schuman and BOL violated Section 10(b) and Rule 10b-5, even if scienter were properly to be required in Commission injunctive actions under that Section and Rule.

1. The Defendants' Conduct on March 15 and 16, 1972, Was Intentional and Knowing, Thus Satisfying Any Scienter Requirement.

As we have seen, supra, pages 9 to 16, the evidence adduced at trial demonstrates that Daniel Schuman, acting in his official corporate capacity, disclosed material, nonpublic, corporate information to certain securities analysts and others during the course of personal interviews, an automobile ride, and in telephone conversations; the record further demonstrates that he knew exactly what he was doing throughout each of the days in question. 81/ In this

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79/ Bucklo, "The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder", 29 Stan. L. Rev. 213, 214, 218-220 (1977).

80/ Cf. Arthur Lipper Corp. v. Securities and Exchange Commission, supra, 547 F.2d at 180-181; McLean v. Alexander, 420 F. Supp. 1057, 1081 (D. Del., 1976).

81/ In assessing the giving of BOL's earnings estimate to Mr. Dorfman, it is significant that Mr. Schuman previously had determined to make the company's estimate public when he was advised of the rumor that he had earlier leaked an earnings estimate to an FDS analyst. At that time, he "instantly decided that [he] * * * was going to go with a number" (JA 392) and that he "was going to release a number to the press" (JA 275). Thus, prior to the first conversation with MacCallum, Mr. Schuman already "has made up [his] * * * mind that [he] * * * was going to go the Wall Street Journal route as the fastest route" (JA 392). Mr.

(footnote continued)

connection, the remarks of the district court with respect to the intentional nature of Mr. Schuman's conduct bear emphasis:

> "I had concluded in my own mind that the activities of March 16 demonstrated the requisite intent. I was persuaded by that primarily from the testimony of Mr. Schuman, who, by what he told me on direct and cross examination, caused me to conclude that he was competent and in full command of his senses and judgment on March 16, 1972, when he was serving as chairman of the board of Bausch & Lomb" (JA 557). 82/

This case thus presents a situation substantially similar to Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171 (C.A. 2, 1976). In that case, this Court assumed, without deciding, that the Hochfelder scienter definition applied to administrative proceedings instituted by the Commission, 83/ but stated that Hochfelder does not require proof that the defendants intended to act in "knowing violation of the law" Id. at 181. 84/ In Lipper, the petitioners engaged in a practice of "give ups," whereby they refunded part of the brokerage commissions they earned with knowledge that the portion refunded was not being returned to the proper party. This Court held

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81/ (footnote continued)

Schuman even conceded in his testimony: "I knew I was going public. Maybe that had some effect on me * * *. I didn't expect to talk to MacCallum. I guess maybe that partly threw me. And he said, '60 cents.' I just kind of responded" (JA 393).

82/ Similarly, there is no evidence in the record which indicates that Mr. Schuman was not competent and in full command of his senses and judgment on March 15, 1972, during his interview with Wien and Clancy.

83/ In Lipper, however, this Court distinguished administrative proceedings and private damage actions, on the one hand, from injunctive actions on the other. As to the latter actions, this Court declined even to assume, arguendo, that scienter applied at all. 547 F.2d at 180, n.6.

84/ Mr. Schuman testified that, as of March 15, 1972, that BOL had not made any public disclosures with respect to those items of information which he disclosed on those days and which the Commission alleged were material. See pp. 11-12, supra.

such conduct to be a violation of Section 10(b) and held that "[i]t is no answer that petitioners may not have realized that this 'cunning device' was a fraud" 547 F.2d at 181. Likewise, BOL's and Mr. Schuman's selective disclosures of numerous items of material, nonpublic information, by destroying the parity of information in the marketplace, also operated as a fraud; their alleged failure either to perceive or appreciate this fact is no answer to the charge that they violated the federal securities laws, for, as we previously have noted, the record demonstrates that Mr. Schuman knowingly and intentionally made such disclosures.

Such a distinction between intentional and inadvertent conduct served as the basis of this Court's decision in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (1976), where this Court, in a private action for damages, distinguished the conduct of the accountants involved therein from the conduct of the defendants in Hochfelder. The theory of liability in Hochfelder was premised on negligence because the accountants had not been aware of facts the plaintiffs alleged they should have known; in Herzfeld, however, this Court noted that the audit had been made with "admitted awareness of the facts" (540 F.2d at 29) and stated:

> "The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports on which Herzfeld relied to his damage."

Id. at 37. Likewise, the case at bar is premised on evidence demonstrating a pattern of knowing and intentional conduct.[85/]

85/ The Supreme Court in Hochfelder noted that, at a minimum, Section 10(b) "was intended to prescribe knowing or intentional misconduct." 425 U.S. at 197.

In addition, consistent with the holding in Herzfeld, the Court of Appeals for the Ninth Circuit in United States v. Charnay, 537 F.2d 341, certiorari denied ___ U. S. ___, 97 S. Ct. 528 (1976), recently upheld the sufficiency of a criminal indictment alleging violations of Section 10(b) and Rule 10b-5. Describing the type of scienter required, the Charnay court (id. at 352) quoted from this Court's decision in United States v. Pelz, 433 F.2d 48 (1970), to the effect that:

> "The Herlands article [86/] concluded it was necessary only that 'the prosecution establishes a realization on the defendant's part that he was doing a wrongful act,' 21 Va. L. Rev. at 149. We accept this with the qualifications, doubtless intended by the author, that the act be wrongful under the securities laws and that the knowingly wrongful act involve a signficant risk of effecting the violation that has occurred." (footnote omitted)

Later, in its opinion denying rehearing, the Charnay court approved the articulation of the scienter requirement by one member of the panel that "the intent necessary * * * is merely that of intending to do the acts prohibited, rather than intent to violate the statute." 87/ Id.

86/ Herlands, "Criminal Aspects of the Securities Exchange Act of 1934" 21 Va. L. Rev. 139 (1934).

87/ With respect to this formulation of scienter, this Court stated in Arthur Lipper Corp. v. Securities and Exchange Commission, supra, 547 F.2d at 181, 187:

> "Indeed, even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally necessary for conviction. The first proposition seems implied by the rule Ignorantia juris non excusat. Hall, Criminal Law 288 (2d ed., 1961). And the second, of course, follows from the first. Perkins, Criminal Law 745 (2d ed., 1969). See ALI, Model Penal Code §§1.13(12), 2.02(2)(a) & (b); Ellis v. United States, 206 U. S. 246, 257, 27 S. Ct. 600, 602, 51 L. Ed. 1047 (1907), where, in rejecting a claim that knowledge of the law was required for conviction under a statute that included the word 'intentionally,' Justice Holmes said, 'If a man intentionally adopts certain conduct in certain circumstances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent'" (emphasis supplied).

See also, United States v. Benjamin, 328 F.2d 854, 862 (C.A. 2), certiorari denied sub nom. Howard v. United States, 377 U.S. 953 (1964).

at 358.[88/] As we have demonstrated, the evidence in the record establishes that Mr. Schuman acted intentionally on March 15 and 16 in disclosing material, nonpublic information to certain analysts and others. Since BOL's officer's conduct satisfied the requisite _scienter_ standard in _Charnay_ for criminal violations of Section 10(b) and Rule 10b-5, _a fortiori_ it is sufficient to satisfy any _scienter_ standard which might be found to apply in this civil action for equitable relief.

2. _Reckless Conduct is Sufficient to Satisfy the Scienter Requirement Articulated by the Supreme Court in Ernst & Ernst v. Hochfelder, and the Defendants Conduct Here Was, at the Least, Reckless._

At common law, proof of the defendant's intent to mislead or defraud was a necessary predicate to establish liability and to entitle the plaintiff to recover damages in a tort action for deceit or misrepresentation.[89/] The common law also came to regard a defendant's reckless conduct in certain circumstances as involving a degree of culpability equivalent to conduct engaged in with an intent to mislead or defraud, such that a plaintiff could recover damages in an action for deceit or misrepresentation upon a showing of the defendant's recklessness and the other elements required to be established.[90/] Likewise, in articulating the elements necessary

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88/ The _Charnay_ court (537 F.2d at 358) also stated that its two formulations of the _scienter_ standard were consistent with _Hochfelder_.

89/ _Derry_ v. _Peek_, 14 App. Cas. 337 (1889); W. Prosser, _The Law of Torts_ (4th ed., 1971) (hereinafter "Prosser") §107 at 699-704.

90/ _Ultramares Corp._ v. _Touche_, _supra_, 255 N.Y. at 186, 189, 174 N.E. at 447-448 (1931); Prosser, §107 at 701; F. Harper & F. James, _The Law of Torts_, §7.3, at 534-535 (1956).

for recovery in implied private damage actions under Section 10(b) and Rule 10b-5 prior to Hochfelder, this Court and others have held that reckless conduct can rise to a level of culpability sufficient to warrant the imposition of damages. 91/ And although the Supreme Court in Hochfelder chose

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91/ Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (C.A. 2, 1973) (en banc); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (C.A. 2, 1971); Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 868 (Friendly, J., concurring); Clegg v. Conk, 507 F.2d 1351 (C.A. 10, 1974), certiorari denied, 422 U.S. 1007 (1975); Vohs v. Dickson, 495 F.2d 607, 622 (C.A. 5, 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (C.A. 5), certiorari denied, 419 U.S. 873 (1974); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 270 (C.A. 3) (Adams, J., concurring and dissenting), certiorari denied, 409 U.S. 874 (1972). See 3 L. Loss Securities Regulation 1766 (2 ed., 1961); 6 id. at 3884 (Supp., 1969) where Professor Loss argues for "some sort of watered-down scienter element" under Rule 10b-5.

With respect to the temptation to rely upon and adhere to the common law of fraud in examining those decisions which have refined the definition of scienter, it is noteworthy in that regard to recall the Supreme Court's statement that

> "There has * * * been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue."

Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 194. Thus, strict adherence to common law fraud concepts in an action under the antifraud provisions of the Securities Exchange Act is to be avoided inasmuch as "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." Blue Chip Stamps v. Manor Drug Stores, supra, 421 U.S. at 744-745.

To the extent, however, that common law fraud concepts continue to remain viable in connection with an analysis of activities within the purview of the antifraud provisions of the Securities Exchange Act, that viability is premised upon the facts that "the courts have adapted the common law of fraud to the commercial

(footnote continued)

to do no more than simply to suggest the question in view of the facts and pleadings in that action, numerous courts have interpreted the Hochfelder decision to mean that reckless conduct is a sufficient predicate for civil damage liability in private actions under Section 10(b) and Rule 10b-5. 92/

The Commission does not in any way suggest that the individual defendant herein, Mr. Schuman, personally profited from his violative conduct. It was not necessary for him to do so. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra, 495 F.2d 228; Securities and Exchange

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91/ (footnote continued)

transactions of our society" and that "the content of the common-law fraud has not remained static" but instead "has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 192, 193.

See, e.g., Clegg v. Conk, supra, 507 F.2d at 1361, where the court remarked that "there must be kept constantly in mind the teaching of Stevens v. Vowell [343 F.2d 374, 379 (C.A. 10, 1965)] that the federal securities acts are not frozen into the old common law patterns; and that they must be interpreted flexibily and progressively, not technically nor grudgingly, to fairly effectuate their remedial purpose."

92/ See Securities and Exchange Commission v. Universal Major Industries, Corp., supra, 546 F.2d at 1047; Sunstrand Corp. v. Sun Chemical Corp., [Current] CCH Fed. Sec. L. Rep. ¶ 95,887 at p. 91,260 (C.A. 7, 1977); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (C.A. 7, 1976); McLean v. Alexander, supra, 420 F. Supp. at 1080-1081; Bartels v. Algonquin Properties, Ltd., [Current] CCH Fed. Sec. L. Rep. 95,870 (D. Vt. 1977); Manheim v. Wood, Walker & Co., [Current] CCH Fed. Sec. L. Rep. ¶ 95,848 (S.D. N.Y., 1977); Rolf v. Blyth Eastman Dillon & Co., Inc., [Current] CCH Fed. Sec. L. Rep. ¶ 95,843 (S.D. N.Y., 1977) Franke v. Midwestern Oklahoma Development Authority, [Current] CCH Fed. Sec. L. Rep. ¶ 95,786 (W.D. Okla., 1976); Coleco Industries, Inc. v. Berman, 423 F. Supp. 275 (E.D. Pa., 1976); Siclari v. Rio De Oro Mining Co., [Current] CCH Fed. Sec. L. Rep. ¶ 95,672 (S.D. N.Y., 1976); Hirsh v. DuPont, [Current] CCH Fed. Sec. L. Rep. ¶ 95,645 (S.D. N.Y., 1976); Rich v. Touche Ross & Co., 415 F. Supp. 95, 101 (S.D. N.Y., 1976). See also, Bucklo, "The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder", 29 Stan. L. Rev. 213, 219, 227-240 (1977).

Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d 833; Securities and Exchange Commission v. Lum's Inc., supra, 365 F.Supp. 1046. Nor does the Commission contend that the disclosures he made were inaccurate, or designed improperly to "jiggle" the market price of BOL's securities.[93/] The fraud and deception perpetrated on investors is all the more telling because the inside information Mr. Schuman disclosed was, in fact, accurate. The Commission contends, however, and the evidence in the record demonstrates, that BOL's and Mr. Schuman's conduct on the dates in question was in reckless disregard of

— their fiduciary obligations to BOL's shareholders and the investing public;

— the New York Stock Exchange's policies on the dissemination of material, nonpublic information with which BOL agreed to adhere to in its listing agreement;

-- BOL's own alleged past practices regarding the release of corporate information to the public;

— plain common sense; and

-- the proscriptions of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

Assuming, arguendo, that the Commission is bound by a "reckless disregard" standard,[94/] the evidence adduced in the record establishes that the

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93/ JA 150.

94/ The district court cursorily adverted to certain of this Court's prior decisions in private damage actions which hold that reckless disregard for the truth is sufficient to establish liability under Section 10(b) and Rule 10b-5 (JA 185-186), but then concluded, in light of its finding that material, nonpublic corporate information had been selectively disclosed in a single telephone conversation, that Mr. Schuman's "behavior certainly does not establish recklessness verging on intent to deceive, manipulate, or defraud" (JA 189). But, that determination was based upon numerous errors: the district court (1) applied an incorrect legal standard (see discussion, infra, pp. 66-86), which resulted in a singularly narrow

(footnote continued)

defendants' repeated dissemination of material, nonpublic corporate information to a few analysts and other individuals on March 15 and 16 amounted to "an extreme departure from the standards of ordinary care and which present[ed] a danger of misleading buyers or sellers that are either known to the defendant or are so obvious that the actor must have been aware of it." 95/

During the week of March 13, 1972, and for approximately the preceding five years, Mr. Schuman was BOL's principal liaison with the financial community. In this connection, Mr. Schuman testified that BOL was "very concerned with this whole question of materiality, and the only person who could talk about such [non-public] information was * * * [him]self" (JA 215). 96/ Yet, in spite of this purported concern regarding materiality, BOL did not have any written policies and procedures to be followed in releasing corporate information (JA 217). 97/

94/ (footnote continued)

holding regarding the materiality of the evidence adduced by the Commission; (2) refused to weigh certain evidence establishing that Mr. Schuman repeatedly disclosed BOL's first quarter earnings estimate, which "[o]bviously * * * is among the most material of all conceivable revelations" (JA 163), at a time when that information had not yet publicly been made available; and (3) without analysis or discussion, summarily disposed of other evidence which establishes a pattern of violations by the defendants by remarking that "[t]he Commission's efforts to prove 'similar acts' were not convincing" (JA 174).

95/ Franke v. Midwestern Oklahoma Department Authority, supra, [Current] CCH Fed. Sec. L. Rep. ¶95,786 at p. 90,850.

96/ Mr. Schuman further testified that two other named BOL officers were delegated this responsibility when he was away (JA 215-216).

97/ The BOL Employee Handbook entitled "Facts About Your Company," as of the dates of the events in issue, stated in pertinent part:

(footnote continued)

Notwithstanding his stated serious concern over the "question of materiality,"[98/] Mr. Schuman selectively disclosed material, nonpublic, information concerning BOL and one of its principal products, Soflens, during an interview on the afternoon of March 15, 1972, with Wien and Clancy, and continued this selective disclosure on March 16 at a morning interview and automobile ride with Mr. MacCallum of FDS,[99/] and that afternoon,

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97/ (footnote continued)

> "When a nation, a business concern, or any other group works toward a common goal, a code of behavior is necessary to protect the rights of the individual and preserve group unity. In the common interest of the people of Bausch & Lomb, certain standards of behavior have been established to guide you in your daily relationships. Committing any of the following acts may result in disciplinary action which, in turn, might result in termination of your employment with the Company.
>
> * * *
>
> "34. Divulging confidential data or information relating to Company business and operations to unauthorized persons." (Ex. 31-32.)

See also, the Pamphlet entitled, "Your Future With Bausch & Lomb," (Ex. 34-36) where the identical admonition is restated.

As of the dates of the trial of this action, BOL did not have any specific written policies or procedures regarding the dissemination of inside information. The document entitled "Disclosure of Company Information," referred to by the district court (JA 176) as 'purporting to reduce to writing BOL's policies and procedures," which was not introduced into evidence at trial and which the district court conceded was presented to it by BOL's counsel after the trial, apparently was created for the benefit of the district court.

98/ See Point III, infra, pp. 66 to 86.

99/ These interviews were not accidental, spur-of-the-moment occurrences which developed as a result of analysts happening to stop by BOL's offices in Rochester while passing through that city. These meetings, in fact, had been tentatively scheduled well in advance of the interview date. When informed of the tentative scheduling of these interviews, Mr. Schuman agreed to keep the appointments. With respect to the disclosures to the analysts, it should be noted that Mr. Schuman revealed, as if acting in a pattern, virtually the same items of material information in each of the analyst interviews.

when, in the presence of Burkhead, the analyst from Smith, Barney & Co., and after Mr. Shuman already had determined to release BOL's earnings figures to the press, [100/] he twice telephoned MacCallum to reveal prematurely BOL's first quarter earnings estimate to him. (See p. 14 *supra*.)

Shortly after his second telephone call to MacCallum, and as if in an attempt to remedy the breach caused by his disclosures of BOL's earnings, while Burkhead was in his office, Mr. Schuman called *Wall Street Journal* columnist Dan Dorfman, and revealed BOL's earnings estimate to Dorfman as well (JA 276-277). Although Mr. Schuman had "a clear impression that [Dorfman] * * * had already written a story which related to the rumor," (JA 278) and even though Mr. Schuman guessed he was not sure he knew what Mr. Dorfman was going to do with what he had been told, no press release was forthcoming from BOL that afternoon (JA 279). Instead, Mr. Schuman, still in the presence of Burkhead, continued to disclose BOL's earnings estimate to numerous analysts, institutional investors and others who telephoned BOL that afternoon (JA 282-286, 396-398). And he made these selective disclosures of BOL's earnings figures while those in possession of critical nonpublic information continued trading in BOL's securities on the New York Stock Exchange and for several hours more on the Pacific Stock Exchange.

Mr. Schuman's determination not to issue a press release on the afternoon of March 16, on the stated ground that he did not have "the time or luxury to go through that whole process," is, at best, implausible. A little over two weeks earlier, when late one afternoon an analyst had contacted

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100/ See discussion, *supra*, pp. 13-14, 48-49, n. 81.

BOL and inquired about a rumor he heard that BOL had halted Soflens shipments, the company was able to issue a press release early the next morning with minimal effort (Ex. 27, 137-148). 101/

In addition, Mr. Schuman's decision not to indulge in the "luxury" of a press release, but instead to call Dan Dorfman, constituted a blatant disregard of the advice regarding the proper procedures for the release of information found in the New York Stock Exchange Manual, a copy of which was maintained in BOL's files (Ex. 136) and the relevant portions of which are set forth in the margin, 102/ and also a significant deviation from BOL's usual practice of preparing a press release to publicize company

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101/ BOL's secretary prepared a draft press release at home that evening, which was cleared by telephone early the next morning with Mr. Schuman in Mexico and issued with the minor revisions suggested by Mr. Schuman.

102/ The New York Stock Exchange Manual provides in pertinent part:

> "TIMELY DISCLOSURE"
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> "Timely and Adequate Disclosure of Corporate News"
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> "A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange."
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> * * *
>
> "A corporation should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations" (Ex. 222).

(footnote continued)

announcements and immediately issuing the release to Dow Jones, Reuters,

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102/ (footnote continued)

"PROCEDURE FOR PUBLIC RELEASE OF INFORMATION

"Immediate Release Policy

"The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press FOR IMMEDIATE RELEASE."

* * *

"Annual and quarterly earnings, dividend announcements, acquisitions, mergers, tender offers, stock splits, and major management changes are examples of news items that should be handled on an immediate release basis. News of major new products, contract awards, expansion plans, and discoveries very often fall into the same category. Unfavorable news should be reported as promptly and candidly as the favorable. Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers a management's reputation for integrity" (Ex. 225) (emphasis supplied).

"Dealing With Rumors or Unusual Market Activity"

"The market action of a company's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified. If they are correct, however, an immediate, candid statement to the public as to the state of negotiations or the state of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience which may be caused and even though the matter may not as yet have been presented to the company's Board of Directors for consideration."

* * *

(footnote continued)

The New York Times and the local press (Ex. 148-153). 103/

The unreasonableness of Mr. Schuman's purported reliance on Dan Dorfman to publish BOL's earnings estimate, is further evidenced by the fact that Mr. Schuman knew any story by Dorfman could not appear in the paper until the following day and conceded that he was not sure what Dorfman would do with the information (JA 279).

102/ (footnote continued)

"Release to Newspapers and News Wire Services"

"News which ought to be the subject of immediate publicity must be released by the fastest available means. The "fastest available means" may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, telegraph, or hand delivery, or some combination thereof. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such news exclusively to the local press outside of New York City would not be sufficient for adequate and prompt disclosure to the investing public" (Ex. 226).

"To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., to Reuters Economic Services, and to Associated Press and United Press International. These releases should also be given to one or more of the newspapers of general circulation in New York City which regularly publish financial news.

"The foregoing distribution of releases should be regarded as a minimum. Many companies may wish to give additional prompt distribution to their releases, particularly to newspapers in cities where the company is headquartered or has plants or other major facilities" (Ex. 227).

103/ The March 1, 1972, press release was issued almost simultaneously to Dow Jones and Reuters. That action was taken, in part, on BOL's Secretary's understanding of the requirements of the New York Stock Exchange Manual (Ex 148-150).

Even if dissemination to one financial newspaper would have satisfied Rule 10b-5, divulging such important information to a columnist cannot be deemed to be effective publication.[104/] Given these facts, it strains credulity to believe that Mr. Schuman could reasonably continue to adhere to his view of "the Wall Street Journal route as the fastest route" (JA 392).

Moreover, Gary Burkhead, the Smith Barney analyst, who remained in Mr. Schuman's office throughout the events of the afternoon of March 16,

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104/ The limited release of the earnings estimate to Dorfman, in the hope that it would be published in his column the next morning, did not constitute proper or effective public dissemination of that information. In Faberge, Inc., supra, 1 SEC Docket, No. 18, at 21, it was claimed that publication of certain information over the Autex wire system resulted in effective dissemination of that information to the public. The Commission disagreed, stating that the transmission on the Autex wire system resulted in disclosure of the information to a limited number of institutional subscribers and not to the public (id. at 24). The Commission also stated that

> "In order to effect a meaningful public disclosure of corporate information, it must be disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information * * *. Proper and adequate disclosure of significant corporate developments can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group."

Ibid. (emphasis supplied.)

Even assuming that disclosure to Mr. Dorfman was the proper method of disseminating the earnings estimate, continued disclosure of the estimate to telephone callers on the afternoon of March 16 was per se unreasonable conduct, since Mr. Schuman knew that the earliest time the estimate could appear in the paper would not be until the next morning.

suggested to Mr. Schuman that BOL issue a press release since he felt that he "had heard information that was important and that [he] * * * considered it desirable to try to get the broadest possible dissemination of that information" (JA 662).

But BOL did not issue a press release (Ex. 20) until approximately 2:00 p.m. on March 17 -- the next day -- and did so only after New York Stock Exchange officials first suggested such a release, 105/ and later informed BOL that the Exchange would not open trading in BOL's stock unless a release was issued (JA 287-288). At that point, "of course, [BOL] started working on one rather promptly" (JA 288). 106/ Certainly the preparation

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105/ If Dorfman had not published his story or had not included in it the specific earnings estimates, presumably BOL stock would have opened for trading the next morning. Hence, it would have been likely that even more investors would have been disadvantaged in trading BOL stock.

106/ It should be noted that once it was forced to do so, BOL was able to prepare and issue a press release on March 17 within a matter of hours. This should be contrasted sharply with Mr. Schuman's stated reasons for determining not to issue a release on the previous day.

When asked if he consulted with anyone about the mechanics of issuing a press release on the afternoon of March 16, Mr. Schuman responded

> "I thought about it, and it isn't the mechanics of the press release, it is the process of getting a press release. A press release has been generally a rather painful thing to get out. It takes time, and generally we do it with a lot of people. A lot of things are in that pot, and I didn't think I had the time or the luxury to go through that whole process, especially this complex situation to get out a press release, and I didn't think, with the time involved, that would be necessarily the best source.
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> "I kind of felt that the Wall Street Journal, with Dorfman writing it, assuming he wrote it properly, would put it in the best light" (JA 281, emphasis supplied).

of an official news release and dissemination to several news sources of wide circulation would have gone a long way toward solving BOL's dilemma. But, under the facts of this case, even that would not have been enough, had it been done, which it was not. After all, BOL never undertook to advise the two exchanges on which it knew its stock was trading, and trading heavily. Only substantial pressure from the New York Stock Exchange, almost a full day later, finally achieved that result (JA 287-288).

Significantly, the press release finally issued by BOL contained not only the first quarter earnings estimate which the district court found to be material, but numerous other items relating to Soflens which the Commission alleged were material, but as to which the district court disagreed. The pattern of disclosure of numerous items of material nonpublic information by BOL officials over a seventeen-day period, and the failure to undertake the proper and necessary corrective measure of issuing a press release in order to effect public dissemination of BOL's first quarter earnings estimate until required to do so by the New York Stock Exchange, casts doubt on the reality of Mr. Schuman's stated "serious concern" over the question of materiality and fails to support the district court's "notion" that Mr. Schuman's release of the earnings estimate was an "uncharacteristic and inadvertent" slip (JA 171). 107/ Moreover, the Commission introduced

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107/ That determination, of course, was premised on the district court's view that the only disclosures of material information occurred in the course of the first telephone conversation with MacCallum and in disregard of the other disclosures of the earnings estimate to telephone callers on the afternoon of March 16.

evidence tending to establish that the events of March 1, 15, 16 and 17, 1972, were not isolated occurrences but, instead, were part of a pattern of conduct which constituted violations of the federal securities laws. 108/

Given the actions occurring over a seventeen-day period as described above, coupled with Mr. Schuman's sophistication and experience in dealing with the financial community, his conduct demonstrates a reckless disregard for his responsibilities, as a chief corporate officer, to BOL's

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108/ For example, evidence was presented that, in October, 1971, Mr. Schuman disclosed a nonpublic earnings estimate for BOL's third quarter to MacCallum (JA 543-545). Similarly, although BOL issued a press release on March 1, 1972, stating that shipments of Soflens had been halted but were expected to resume on the next day, Soflens shipments in fact did not resume until March 10, 1972; BOL never bothered to correct the misinformation in that release even though it had regarded the fact of the halt in Soflens shipments of sufficient import to issue a press release when an analyst inquired about a rumor he had heard concerning the halt in shipment (see discussion, supra, pp. 7-8). And as a final matter, by letter dated October 4, 1973, BOL's Soflens division sent out a "Dear Doctor" letter which described the increased demand for Soflens with a consequent need for "new facilities, additional manufacturing equipment and more people;" and the effect of "working around the clock * * * [to] avoid * * * running completely out of stock" (JA 74). When this letter was called to the attention of BOL's Vice-President of Finance by an employee of a brokerage firm who suggested that the contents of the letter were such that the company should issue a press release, Mr. Stillman requested a copy of the letter and then informed Mr. Schuman that the letter had been sent out to practitioners (Ex 103-105). Messrs. Schuman and Stillman "were concerned about the impact that the letter might have, and immediately began to think in terms of a possibility of a press release" (Ex 105). The company then issued a press release [j]ust as fast as [it] * * * possibly could" (Ex 106).

The district court failed to make any findings of fact with respect to the incidents which occurred in October 1971; March 1, 1972, and approximately October 5, 1973. The district court also failed to make any determination as to whether such conduct violated the federal securities laws, merely stating in conclusory fashion that the "Commission's efforts to prove 'similar acts' were not convincing" (JA 174).

shareholders as well as public investors who were not made privy to the material, nonpublic corporate information which he disclosed, such that he should be found to have violated the federal securities laws.

III. THE INFORMATION SELECTIVELY DISCLOSED BY MR. SCHUMAN WAS MATERIAL WHEN MEASURED BY THE ACCEPTED STANDARD OF WHAT A REASONABLE INVESTOR WOULD CONSIDER IMPORTANT IN MAKING AN INVESTMENT DECISION

A. The Standard to Be Applied.

In determining what is "material" for purposes of the federal securities laws, the courts have attempted to distinguish between information which is likely to cause distortions in the market pricing process and that which is not likely to cause such an ill effect. Measuring information against its effect upon a reasonable investor's decision to buy, sell or hold a security has served to make this distinction. Specifically, the courts have formulated a test designed to determine whether information is "material" to an investment decision by defining as "material" "a fact to which 'a reasonable man would attach importance * * * in determining his choice of action in the transaction in question.'" 109/

Recently, the Supreme Court examined this concept in the analogous context 110/ of the Commission's proxy rules in TSC Industries, Inc., v. Northway, Inc., 426 U.S. 438, 96 S. Ct. 2126 (1976). There, the standard of "materiality" was stated as follows:

109/ Securities and Exchange Commission v. Great American Industries, Inc, 407 F. 2d 453, 459-460 (C.A. 2, 1968) (en banc), certiorari denied, 395 U.S. 920 (1969) (citations omitted). See also, e.g., Rochez Brothers, Inc. v. Rhoades, 491 F. 2d 402, 408 (C.A. 3, 1974), Northwest Paper Corp. v. Thompson, 421 F. 2d 137, 138 (C.A. 9, 1969); Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989, 993 (C.A. 5, 1969); Rogen v. Ilikon Corp., 361 F.2d 260, 266 (C.A. 1, 1966); List v. Fashion Park, Inc., 340 F.2d 457, 462 (C.A.2), certiorari denied sub nom. List v. Lerner, 382 U.S. 811, rehearing denied, 382 U.S. 933 (1965).

110/ In the context of Rule 10b-5, see Santa Fe Industries, Inc. v. Green, supra, 45 U.S.L.W. at 4320, n. 14.

> "* * * an omitted fact [in a proxy statement] is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with Mills' general description of materiality as a requirement that 'the defect have a significant propensity to affect the voting process.' It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the delibera-tions of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

96 S. Ct. at 2133 (footnote omitted).

Thus, the determination of the effect an item or items of information 111/ would have on a reasonable investor is at the very core of the concept of materiality, and the responsibility of making this determination rests, in the first instance, on the trier of fact.

> "* * * [T]he underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him * * *."

Ibid. In making such assessments, if the trial court finds that there is a substantial likelihood that those facts would assume actual significance in the decision-making process of a reasonable shareholder, then materiality

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111/ In measuring the importance of several items of information, a court should weigh both their individual effect and their combined effect on the reasonable investor. See TSC Industries, Inc. v. Northway, Inc., supra, 96 S. Ct. at 2134; Marx v. Computer Sciences Corp., 507 F.2d 485, 491-492 (C.A. 9, 1974).

is established. However,

> "* * * such matters are not subject to determination with certainty. Doubts as to the critical nature of information misstated or omitted will be commonplace. And particularly in view of the prophylactic purpose of the Rule [14a-9 of the Commission's proxy rules, 17 CFR 240.14a-9] and the fact that the content of the proxy statement is within management's control, it is appropriate that these doubts be resolved in favor of those the statute is designed to protect."

Id. at 2132 (citation omitted, emphasis supplied). Like Rule 14a-9 involved in the Northway case, the prophylatic purpose of Rule 10b-5 is well established, and, like proxy statements, the content and timing of disclosure of inside information is peculiarly within the control of the corporation and its insiders. Thus, the Supreme Court's observation in Northway, ibid., that "doubts [should] be resolved in favor of those the statute is designed to protect," is equally applicable to the instant case.

Moreover, there is a question whether the standard of materiality set forth in Northway for proxy statements was intended by the Court to apply as rigorously to insider trading cases brought by the Commission under Section 10(b) and Rule 10b-5, [112/] in light of the differing purposes to be served by the proxy rules and the prohibition against insider trading. The Court in Northway observed that, "if the standard of materiality is unnecessarily low, * * * management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information -- a result that is hardly conducive to informed decision-making." Id. at 2132-2133. The concern for avoiding too much information

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112/ See Santa Fe Industries, Inc. v. Green, supra, 45 U.S.L.W. at 4320 n. 14.

by management which is required to furnish information to shareholders in a proxy statement, translates only awkwardly to the situation where, as here, management is not required to give nonpublic information to some persons, but does so nonetheless. There is no reason to immunize from possible liability for violation of Section 10(b) and Rule 10b-5 such selective disclosure by reason of a very high threshold of materiality. This Court, in an appeal from a Commission injunctive action, decided a few months before the Northway decision, also made a similar distinction. It stated:

> "In cases of the disclosure of inside information to a favored few, determination of materiality has a different aspect than when the issue is, for example, an inaccuracy in * * * a proxy statement * * *; the information takes on an added charge just because it is inside information."

Securities and Exchange Commission v. Geon Industries, Inc., supra, 531 F.2d at 48 (C.A. 2, 1976) (citations omitted).

In assessing the importance of omitted or misrepresented information to a reasonable investor, the courts may examine the "total mix" of information already generally available to investors. Spielman v. General Host Corp., 402 F. Supp. 190, 195 (S.D. N.Y., 1975), affirmed, 538 F.2d 39 (C.A. 2, 1976) (per curiam). Cf. TSC Industries, Inc. v. Northway, Inc., supra, 96 S. Ct. at 2134-2135. If the information has already been adequately disclosed to the public, further disclosure is not necessary. Spielman v. General Host Corp., supra, 402 F. Supp. at 206. 113/

113/ See TSC Industries, Inc. v. Northway, Inc., supra, 96 S. Ct. at 2134-2135. See also, e.g., Johnson v. Wiggs, 443 F.2d 803, 806 (C.A. 5, 1971), in which the court indicates there is no duty to disclose information already in the public domain and readily available.

(footnote continued)

The Supreme Court stated in Northway: "The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to particular set of facts * * * [but] if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality' * * * the ultimate issue of materiality appropriately [may be] resolved 'as a matter of law' * * * *" Id. at 2133.

B. The District Court's Analysis.

In the district court's view, "the elusive concept of materiality" (JA 150) rests on two pillars: information "should not be unduly hypothetical," (JA 151), and, it "can only be ascertained in light of all the information available" to the investing public. (JA 151). Relying heavily on this latter principle, the court below sifted through selected items of information disclosed by Mr. Schuman which the Commission alleged were "material," and determined that, of the total aggregate of information he disclosed, only one item -- BOL's \$.65-\$.75 per share earnings estimate for the first quarter of 1972 which Mr. Schuman disclosed on the afternoon

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113/ (footnote continued)

But cf. Smallwood v. Pearl Brewing Co., supra, 489 F.2d at 605-606, in which the court points out that disclosure in one communication does not necessarily immunize the lack of a similar disclosure in another communication, because each time a shareholder must make an investment decision a new balance must be struck in terms of the information available to him in making that decision.

of March 16 114/ -- rose to the level of materiality. 115/ With respect to this information, the court stated:

> "Obviously, an estimate of earnings is among the most material of all conceivable revelations." (JA 163) [citation omitted].

The district court first considered the March 15, 1972, meeting between analysts Wien and Clancy and Mr. Schuman. There, as we have discussed in the Statement of Facts, supra, pages 9 to 11, the Commission had alleged that the following information was material:

> "A. That an earnings estimate of $5.00 per share for BOL common stock in 1972 then being used by financial analyst, Lewis Sanders was optimistic and that Sanders ought to be more conservative;
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> B. that an earnings estimate of $3.00 per share for BOL common stock for 1972 was too low;
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> C. that BOL was not going to introduce the Aphakic lens in the first quarter of 1972 and that it would be introduced at the end of April or the beginning of May;
>
> D. that the minikit would not be out for the first quarter;
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> E. that BOL could no longer make the statement that Soflens sales were increasing on a week-to-week basis, that Soflens sales had flattened out and that BOL's Soflens sales were being seriously hurt by the flak;
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> F. that BOL was revising its internal estimates of earnings downward;
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> G. that the Soflens sales rate was less than a prior estimate of one lens per practitioner per week." (JA 152-153).

114/ See pp. 13-16, supra.

115/ Specifically, the court below stated:

> "Viewing the 'total mix' of available information, this Court finds that the SEC has not established that Schuman violated §10(b) and Rule 10b-5 in the course of the interviews of March 15 and 16" (JA 159).

The district court then examined the disclosures made by Mr. Schuman on the morning of March 16 to MacCallum, the FDS analyst, which the court deemed to be "substantially similar to those alleged in regard to the Wien and Clancy meeting" (JA 157).

1. Earnings Estimates

The estimates of earnings (items A and B and, perhaps, item F) were discarded simply because it could not "fairly be said" that these "could be characterized as disclosures of earnings." (JA 153) Whether or not the statements can be "labelled" earnings estimates is beside the point. 116/ The relevant consideration in determining materiality is whether the information, either separate items or in the aggregate, likely would be important to a reasonable man in making an investment decision. If, as the district court stated with respect to the \$.65-\$.75 earnings figure, "an estimate of earnings is among the most material of all conceivable revelations" (JA 163), then surely a statement by the Chairman of the Board and co-Chief Executive Officer of a corporation that yearly earnings would be between \$3.00 and \$5.00 a share, and that management was revising its internal estimates (from which an inescapable inference could be drawn that the revision was downward) should have warranted an examination by the district court of the informational content of these disclosures for a reasonable investor, instead of being dismissed out of hand without any analysis. Moreover, when viewed in conjunction with Mr. Schuman's

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116/ "What's in a name? That which we call a rose
By any other name would smell as sweet." Romeo and Juliet, Act II, Scene ii, lines 43-44.

other selective disclosures, the combined importance of all the information to the reasonable investor is, we submit, and demonstrate, infra, pages 73 to 83, beyond question.

2. New Product Information

Information concerning the delays BOL was experiencing in the expected introduction of new Soflens products -- aphakic lenses and the Soflens minikit -- (items C and D, p. 71, supra) was, unlike the earnings estimates discussed above, subjected to analysis. The district court noted that adverse publicity about Soflens had caused investors to discount the value of BOL shares by approximately 50 points between January and March of 1972 (JA 145). Further adverse information, like disclosures that two important new Soflens products would not be introduced, as originally expected, in the first quarter of 1972, would very likely result in a further discounting of the value of BOL stock by investors trading reasonably. Consequently, the district court erred in determining that such information would not be considered important by a reasonable investor.

Although the district court conceded the importance of Soflens to BOL, and recognized the heavy investor interest in BOL that that product created (JA 143, 157-158), the court below apparently was of the view that the delays in the introduction of these new products already had been sufficiently publicized by BOL in letters responding to specific inquiries by individual Soflens customers and that, since the information was already in the "public domain," it no longer was "material" at the time of Mr. Schuman's disclosures. But, none of the letters in question were directed to shareholders

or the investing public (Ex 421-427), and even the sensitive antennae of several respected securities research firms did not pick up their contents (Ex 57, 59). 117/ Thus, it was unreasonable for the district court to assume the information had been absorbed by the marketplace.

More importantly, analysts' reports then circulating in the market and available to investors (Ex 55-57, 58-60, 380-382), 118/ based largely on information provided or confirmed by BOL itself (Ex 59, 382), 119/ indicated that the aphakic lens and the minikit would be introduced shortly, and that the introduction of the aphakics in March would result in increased earnings of approximately $.20 per share (Ex 57, 59, 381-382). Letters to a few consumers are not an adequate substitute for the widespread dissemination of information expected by the financial community and accepted by BOL, 120/ and cannot reasonably be said to meet the standard of full and fair disclosure mandated by the federal securities laws. This is all the more apparent here because the information readily available to the public reflected BOL's outdated

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117/ Seiden & DeCuevas, Inc. and Smith, Barney & Co., in reports dated March 3, 1972, expected the aphakics to be introduced in March, and not April or May as reflected in the company's reponses to customer inquiries.

118/ Presumably, they were available for a price. However, the Smith, Barney report was also described in all relevant detail in a series of dispatches from Dow Jones, a news service with a wide circulation (Ex 380-382).

119/ Before releasing his report, Burkhead was told by Harby, BOL's President, that earnings for the first quarter depended importantly on the introduction of the aphakics and that Burkhead's estimate of earnings was a fair statement (JA 653-659). See p. 10, n. 10, *supra*.

120/ N.Y.S.E. Company Manual, A 22-24, Ex 225-227; Ex 135-136, 148-151.

expectation that the new products would be sold during the first quarter.

Continuing its "materiality" analysis, the district court examined the likely impact of the delayed introduction of these new products on BOL's total financial picture:

> "The potential financial impact of the later introduction of the two products seems insubstantial. An internal forecast of sales of the aphakics for the first quarter of 1972, made in February, estimated receipts of $480,000. At the same time, the estimate for the minikits was $540,000, the two aggregating $1,020,000. Total sales for the first quarter were $42,960,000" (JA 153).

Certainly, an assessment of potential financial impact is relevant to a determination of whether a reasonable shareholder would consider information important in making a decision to buy, sell or hold. But examination of the figures involved demonstrates that the lower court erred here as well.

In assessing materiality, the magnitude of dollar figures on sales, earnings, assets, etc., can be extremely misleading, particularly when, as in the district court's analysis in the instant case, those figures take on a life of their own apart from their expected effect on profit and loss. Soflens was the recognized money-maker for BOL. BOL earned $2.35 per share in 1971, compared to earnings of $1.53 per share in 1970 (JA 143). As explained in a BOL press release, dated January 26, 1972, "the increase in 1971 earnings was due <u>principally</u> to the company's new SOFLENS Contact Lens," (Ex 28, emphasis supplied), and the substantial contribution of

Soflens to BOL's total earnings picture continued in 1972. 121/ The significant expected contribution to earnings of the new products can be easily demonstrated. The same internal figures which the district court quoted, in part, in its opinion forecasted total Soflens sales of $5,910,000 for the first quarter of 1972. Of this total forecast, $1,020,000, or one-sixth, was expected from sales of the new aphakic lenses and minikits (Ex 22). Early in the quarter, Soflens sales had been expected to produce approximately 60% of BOL's total earnings (Ex 17-18). 122/ Clearly, the elimination of such a significant portion of expected Soflens sales would have a severe effect on BOL's overall earnings in the quarter, and thus, in terms of potential profits alone, the timing of the introduction of the new products was extremely significant and would be important information for any reasonable investor. The precise impact on a specific investor might have very well differed, however, depending upon whether the investment objective was short-term (in which case the dismal news regarding the effect of the new products on first quarter earnings was bearish) or long-term (where an investor may have viewed the prospects of subsequent earnings from the later introduction of these new products as bullish).

121/ In a BOL press release, dated April 24, 1972, which announced the first quarter, 1972, results of $.68 per share compared to $.28 per share in 1971, "Daniel G. Schuman, chairman of the board, and Jack D. Harby, president, stated that Soflens earnings accounted for substantially all of the increase over 1971" (Ex 25, emphasis supplied). Also, an article in the Wall Street Journal, on January 19, 1972, based on an interview with Mr. Schuman, quoted Mr. Schuman as saying that the earnings impact of Soflens in 1972 "should be very substantial" (JA 144).

122/ The continuing reliability of this figure can be proven by reference to the final first quarter results. See *supra*, n. 121.

The final factor relied on by the district court in concluding the nonmateriality of Mr. Schuman's disclosures that new Soflens products would not be introduced in the first quarter of 1972, was the testimony by Mr. Schuman and certain of the analysts to whom he revealed the information, that it was not significant (JA 154, 157). In doing so, the district court erroneously ignored the objective standard of the "reasonable investor." As this Court has stated, in assessing the adequacy of certain jury instructions in a private action brought under Rule 10b-5:

> "There could have been no doubt in the jury's mind at the conclusion of the charge that the materiality of the defendants' information was not to be looked at subjectively, through the eyes of the defendants, but rather, objectively, through the eyes of the 'reasonable man.'" 123/

It may be that, in some rare circumstances, a defendant's testimony about the importance of certain information could give some insight into the effect of such information on the reasonable investor. This is not such a case. Although Mr. Schuman testified that the delay in the introduction of the new products was not important, this conclusion is flatly contradicted by BOL's internal forecasts. (See pages 75 to 76, *supra*). Moreover, as we have seen, *supra*, p. 10, n. 10, Harry Hooley, BOL's Controller, who prepared these figures and discussed the drop in the earnings forecast with Mr. Schuman on March 13 (Ex 110-114), testified that the delayed introduction of aphakics and the minikit had a definite impact on earnings (Ex 119). 124/

123/ *Radiation Dynamics, Inc.* v. *Goldmuntz*, *supra*, 464 F.2d at 889-890 *Cf.*, *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 312 F. Supp. 77 (S.D. N.Y., 1970), *modified*, 446 F. 2d 1301 (C.A. 2), *certiorari denied*, 404 U.S. 1005 (1971).

124/ It is noteworthy that the BOL press release of March 17, issued to dispel the informational imbalance created by Mr. Schuman's selective disclosure of nonpublic information, prominently featured the new product delays as factors responsible for the disappointing earnings (Ex 20). Indeed, they received top billing on the list (Ex 20).

The district court erred in determining that this information, either by itself or together with Mr. Schuman's other disclosures, was not material. In view of investor sensitivity to news about Soflens, available information accurately reporting BOL's previous expectations that the new products would be introduced in the first quarter of 1972, and BOL's internal estimates confirming the importance of these new products to first quarter earnings, a reasonable investor, particularly one interested in BOL as a short-term investment, surely would have considered information that those new products would be delayed as being important.

3. Sales Information

Mr. Schuman's disclosures of BOL sales information (items E and G, p. 71, *supra*) -- that Soflens sales were no longer increasing on a week-to-week basis, had flattened out, were being seriously hurt by "flak," and had declined to a rate below the rate of one lens per practitioner per week (JA 152-153), -- were found by the lower court to be immaterial within the context in which they were disclosed (JA 154), since the analysts to whom the disclosures were made already were aware that unfavorable publicity was causing problems for BOL in sales of Soflens (JA 154, 155).[125/] But, the record below reflects that the adverse publicity concerning Soflens, of which the analysts were aware, did not approach the quality of the details divulged

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125/ As an initial matter, it would appear again that the court below missed the mark. Just as it erred in considering materiality through the eyes of Mr. Schuman, who disclosed the inside information (see p. 9-17, *supra*), it erred in considering it through the eyes of the analysts who received the information. The proper standard, as we have seen, is the impact that such information would have on a reasonable investor.

by Mr. Schuman (Ex 44, 46-59; JA 145).[126/] And even BOL's management

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126/ An analysis by MacCallum, made on March 2, about two weeks prior to the receipt by him of nonpublic information from Schuman, is most revealing (Ex 39-42). MacCallum was purportedly aware of the problems BOL was having in its Soflens sales. In his analysis, the reports of contamination in soft contact lenses were substantially discounted because: any infections attributable to Soflens were minor, with an incidence of minor infection "not materially higher than in the population as a whole;" there was "no evidence" that "Soflens has any capability of harboring virulent organisms, even when improperly sterlized;" and, the Food and Drug Administration appeared to retain its favorable opinion of Soflens (Ex 39-40). Concerning possible competition, the report pointed to "the obvious economic attraction of making a product for $5 and selling it for $65" as a reason for the interest of other firms in entering the field and indicated that the presence of possible competitors, "in a sense, could be viewed as a substantiation of the attractiveness of B & L's position, rather than a detriment to it" (Ex 40). The report also noted that "although we feel reasonably confident that consumer acceptance of the product is increasing, it is also probably true that the considerable and unrelenting level of negative rumors relating to the lens has restrained, to a probably minor degree, purchases of the kits by fitters" (Ex 40, emphasis added).

It may be that the court was impressed with MacCallum's astute prediction of a drop in Soflens sales for the first quarter from 1900 kits to 800 kits made in the same March 2 report. However, during the course of the interview with Mr. Schuman, MacCallum changed his first quarter estimate again, and tested the new figure on Mr. Schuman -- a figure which Mr. Schuman indicated was a good estimate (JA 506-509). Although Mr. MacCallum could not recall the new figure, there was evidence in the record which suggested that the new figure was 500 to 600 kits (JA 473-474). Whatever the figure, it is apparent that MacCallum's understanding of the effect that "flak" had on Soflens sales did not remain constant over time, and, indeed, may have changed during his interview with Mr. Schuman.

Even Smith, Barney, which had withdrawn its buy recommendation on BOL stock, did not apprehend the full extent of the Soflens sales woes. Though recognizing the "flak," the report noted that "these concerns do not seem to be supported by the available evidence" (Ex 58-59). Moreover, Smith, Barney still predicted first quarter earnings of $.80 to $1.00 per share, depending on the introduction of the aphakics (Ex 59).

was not aware of the extent and actual effect of faltering Soflens sales, in dollars and cents, until March 9.

Thus, if the lower court had applied the correct standard of materiality, it would have found that Mr. Schuman's disclosures that Soflens sales were not increasing, were flattening, were being seriously hurt, and were declining, would be of considerable importance to a reasonable investor, which substantially altered the "total mix" of available information concerning Soflens, especially in conjunction with Mr. Schuman's other disclosures.

4. The Analysts' Reactions

The Commission contended that the immediate sales of BOL stock by the FDS and Brokaw firms, which closely followed the selective disclosures made to them by Mr. Schuman, supports the inference that the disclosures were material.[127/] The lower court apparently concluded instead that other adverse publicity concerning Soflens might have prompted the sales and noted that the analysts did not react uniformly to the disclosures.

But, the record reflects that from an inventory of 72,000 shares of BOL stock on March 15, Wien and Clancy's firm reduced their position in BOL to zero on March 16 (Ex 75-78; JA 154). MacCallum telephoned his office immediately following the interview with Mr. Schuman (JA 517-519, 467-475), and Hoitsma, the recipient of that call, thereupon emptied the

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127/ See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra, 495 F.2d at 232; Securities and Exchange Commission v. Texas Gulf Sulphur, Inc., supra, 401 F.2d at 851; Investor's Management Co., Inc., supra, 44 S.E.C. 633.

accounts under his control of all their BOL stock, (JA 477, 94), and passed the information along to the salesmen of the firm to notify their customers. (JA 475-477). Hence, a prompt turnabout, closely following the receipt of non-public information, appears in the instant case. See, e.g., Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 851.

We do not disagree that the district court was correct in recognizing that the adverse publicity concerning Soflens had had an impact on the price of BOL stock, which dropped from $194.75 on January 28, 1972, to $145 on March 10 (JA 145). But, BOL was still trading at $137 a share at the close on March 15 (JA 162). Immediately thereafter, on March 16, it closed at $125.25; on March 17, there was a rash of sell orders; and, on March 20, when trading reopened after BOL publicly disclosed the information which had been previously revealed to the analysts, the stock closed at $105 (ibid). The trading volume is also significant. The volume of 348,000 shares, on the day of March 16, surpassed the volume of trading in any single week of 1972, prior to March 16 (Ex 417-419). The adverse publicity, which the district court labelled a "dark cloud," took on singularly ominous proportions on March 16. But, whatever its proportions, the district court's "dark cloud" concept cannot by itself explain the extraordinary volume of trading and sharp drop in price. The "dark cloud" had surrounded BOL for months, [128/] and had never before effected such a considerable short-term impact.

128/ Reports similar to the March 15 revelation that Warner-Lambert was continuing discussions aimed at the eventual marketing of a product to compete with Soflens (JA 164) had been pooh-poohed by those watching BOL closely (Ex 40, 51, 55), including those who had already soured on Soflens' prospects (Ex 58-59). The reports of a possible Senate investigation (JA 164) had been out since March 2 and 3 (Ex 390-391) and would have been stale by March 16.

Those privy to Mr. Schuman's disclosures possessed information fundamentally different from the information available to public. The public, at best, had only the "dark cloud," while the analysts and their customers had the "dark cloud" and Mr. Schuman's revelations which confirmed the substantial impact that the adverse publicity had had on Soflens sales and provided additional information (delays in the introduction of the new products) which further reflected on BOL's short-term misfortunes. It was this disequilibrium in information which enabled certain persons to receive prices for their stock in excess of the prices they would have received had the information been available equally to all.

The district court was also impressed by the lack of a uniform reaction by analysts to the information conveyed by Mr. Schuman. Whether uniform or not, the court below ignored the fundamental import of the fact that all the analysts acted on the information. Unlike his fellows, Mr. Sanders bought BOL stock (JA 151-152). Unlike the public, Mr. Sanders, the recipient of inside information, at least had the opportunity to make an investment decision based on such information. And, as we have already pointed out, the nature of the inside information was such that it could very well have been perceived differently by persons with long-term investment goals than with short-term ones.

As this Court noted in Texas Gulf Sulphur, the courts, as an initial matter, should preserve informational access equality in the market. Once that circumstance occurs, the individual skills and wills of individual

investors take over, beyond the protective powers of the courts. Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 851-852. In the instant case, as we have previously demonstrated, Mr. Schuman's selective disclosures, particularly when taken together, would be important to a reasonable investor, and this conclusion is buttressed, not refuted, by the analysts' actions following receipt of that information.

IV. THE DISTRICT COURT'S DENIAL OF AN INJUNCTION AND OTHER EQUITABLE RELIEF WAS BASED, IN PART, ON THE COURT'S ERRONEOUS VIEW THAT THE INJUNCTION SOUGHT BY THE COMMISSION WAS AN EXTRAORDINARY REMEDY WHICH SHOULD NOT BE USED "IN LIEU OF ADMINISTRATIVE REGULATIONS," AND THAT THE COMMISSION SHOULD EXERCISE ITS ADMINISTRATIVE AUTHORITY TO ACCOMPLISH THE RESULT SOUGHT BY THE REQUEST FOR WRITTEN PROCEDURES FOR BOL. THE DISTRICT COURT ALSO ERRED IN CONSIDERING EVIDENCE NOT PROPERLY BEFORE THE COURT IN CONNECTION WITH ITS DETERMINATION TO DENY THE REQUESTED RELIEF.

In assessing the need for the relief requested by the Commission in the instant case, the district court misperceived the nature of an injunction under the federal securities laws, ignored the necessity for the exercise of agency discretion in determining whether to procede by rulemaking or litigation, failed to recognize the legal and practical limitations on the Commission's rulemaking powers, and considered evidence which was not properly introduced into evidence at trial.

A. The Injunction Sought By The Commission Is a Mild Prophylactic Remedy

In declining to issue the injunction requested by the Commission, the district court stated that "injunctions as extraordinary remedies, should be issued when they are needed in extraordinary situations and should not be utilized generally in lieu of administrative regulations" (JA 175) (footnote omitted). This statement evidences the lower court's fundamental

misperception of the remedial nature of the injunctive relief which the federal securities laws expressly authorize the Commission to seek, and the federal district courts to grant, in appropriate circumstances.

The courts have long recognized the fundamental distinction between private actions seeking injunctions, where there is no adequate remedy at law, and actions by the Commission seeking merely to enforce compliance with the federal securities laws. Rather than being "extraordinary," the injunctive relief requested by the Commission is a "mild prophylactic" to be issued to effectuate the salutary goals of the federal securities laws. 128/ As this Court recently stated:

> "Unlike private actions, which are rooted wholly in the equity jurisdiction of the federal court, SEC suits for injunctions are 'creatures of statute.' '[P]roof of irreparable injury or the inadequacy of other remedies as in the usual suit for injunction' is not required. * * * We noted in SEC v. Torr, 87 F.2d 449, 450 (2d Cir. 1937);
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>> As the issuance of an injunction in cases of this nature has statutory sanction, it is of no moment that the plaintiff has failed to show threatened irreparable injury or the like, for it would be enough if the statutory conditions for injunctive relief were made to appear.
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> This principle has been applied in granting both permanent injunctions and preliminary injunctions, and we perceive no reason why it should not be applicable here."

128/ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 193. See also, Securities and Exchange Commission v. Geon Industries, Inc., supra, 531 F.2d at 56; Securities and Exchange Commission v. Manor Nursing Centers, supra, 458 F.2d at 1096; Mitchell v. Pidcock, supra, 299 F.2d at 287; Securities and Exchange Commission v. Scott, Gorman Municipals, Inc., 407 F. Supp. 1383, 1387 (S.D. N.Y., 1975); Securities and Exchange Commission v. Graye, supra, 156 F. Supp. at 547 (S.D. N.Y., 1957). The view that such statutorily authorized injunctions are not extraordinary is consistent with the view taken of injunctions sought pursuant to other regulatory statutes. See, e.g., United States v. W.T. Grant Co., supra, 345 U.S. 629 (suit under the antitrust laws); Hecht Co. v. Bowles, supra, 321 U.S. 321 (suit under the Emergency Price Control Act).

Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 808 (C.A. 2, 1975) (footnote and citations omitted). 129/

B. Other Errors

By suggesting that an injunction should not be issued when the Commission might, instead, issue regulations to provide "concrete guidance" (JA 174-176, 189 n. 5), the district court ignored the necessity for agency discretion in determining whether to seek to prohibit a practice prospectively through rulemaking, or to proceed to correct a violation of the law which already has occurred through remedial enforcement action. As the Supreme Court has recognized:

> "Not every principle essential to the effective administration of a statute can or should be cast immediately into the mold of a general rule. Some principles must await their own development, while others must be adjusted to meet particular, unforeseeable situations. In performing its important functions in these respects, therefore, an administrative agency must be equipped to act either by

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129/ Accord, Securities and Exchange Commission v. Advance Growth Capital Corp., 470 F.2d 40, 53 (C.A. 7, 1972); United States v. Diapulse Corp. of America, 457 F.2d 25, 28 (C.A. 2, 1972); Securities and Exchange Commission v. Tax Service, Inc., 357 F.2d 143, 145 (C.A. 4, 1966); Bradford v. Securities and Exchange Commission, 278 F.2d 566, 567 (C.A. 9, 1960); Securities and Exchange Commission v. Scott, Gorman Municipals, Inc., supra, 407 F. Supp. at 1387.

See also Henderson v. Burd, supra, 133 F.2d at 517, an injunctive action brought under the Emergency Price Control Act, where this Court said:

> "The contention that plaintiff [Price Administrator] failed to prove the existence of the usual equitable grounds for relief, such as irreparable damage, is plainly irrelevant. Where an injunction is authorized by statute it is enough if the statutory conditions are satisfied." (citation omitted)

> general rule or by individual order. To insist upon one form of action to the exclusion of the other is to exalt form over necessity.
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> * * *
>
> "[T]he problem may be so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule. In those situations, the agency must retain power to deal with the problems on a case-to-case basis if the administrative process is to be effective. There is thus a very definite place for case-by-case evolution of statutory standards. And the choice made between proceeding by general rule or by individual _ad hoc_ litigation is one that lies primarily in the informed discretion of the administrative agency."

Securities and Exchange Commission v. _Chenery Corp._, 332 U.S. 194, 202-203 (1947) (citation omitted).[130/] More recently, in _Securities and Exchange Commission_ v. _Capital Gains Research Bureau_, _supra_, 375 U.S. 180, where the Commission sought to enjoin violations of the antifraud provision of the Investment Advisers Act of 1940,[131/] the Supreme Court held that an injunction would lie notwithstanding the fact that the Commission had not adopted rules or regulations specifically proscribing the fraudulent practice in question and stated that:

> "The legislative history [of the statute authorizing the Commission to define fraudulent practices by rules and regulations] offers no indication * * * that Congress intended such rules to substitute for the 'general and flexible' antifraud provisions which have long been considered necessary to control 'the versatile inventions of fraud doers.'"

_Id._ at 199.

130/ _See also_, _National Labor Relations Board_ v. _Bell Aerospace_, 416 U.S. 267, 292 (1974); _National Labor Relations Board_ v. _Wyman-Gordon_, 394 U.S. 759, 772 (1969) (Black, J. Concurring); _Arkansas-Best Freight Systems, Inc._ v. _Occ. Safety & Health Rev. Comm._, 529 F.2d 649, 656 (C.A. 8, 1976); _National Labor Relations Board_ v. _Wentworth Institute_, 515 F.2d 550, 556 (C.A. 1, 1975); _GTE Service Corp._ v. _Federal Communications Commission_, 474 F.2d 724, 731 (C.A. 2, 1973).

131/ 15 U.S.C. 80b-1, _et seq._

In any event, the conduct involved in the present case — the selective disclosure of material, nonpublic corporate information — is not novel or unique. To the contrary, as we have seen, it has long been recognized that such conduct is violative of Section 10(b) of the Securities Exchange Act and Rule 10b-5. And, as we have previously demonstrated, both BOL and Mr. Schuman were well aware of the nature of their activities.

The district court avoided ruling on the Commission's request that BOL and Mr. Schuman be ordered to adopt written procedures designed to ensure future compliance with Section 10(b) and Rule 10b-5 in connection with the disclosure of material, nonpublic corporate information, noting that BOL, after trial, had presented such procedures to the court, and that, in any event, such procedures might best be prescribed by the Commission pursuant to its administrative powers. The court cited, for the latter proposition, Securities and Exchange Commission v. Geon Industries, Inc., supra, 531 F.2d at 55.[132/] But, that case dealt with broker-dealers. Ibid. Although the Commission has wide-ranging authority to regulate the activities of broker-dealers,[133/] it has no comparable power over publicly-

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132/ JA 175-176.

133/ See, e.g., Section 15 of the Securities Exchange Act of 1934, 15 U.S.C. 78o.

held industrial corporations. Thus, the lower court's reference to the Geon decision evidences that its consideration of the need for, and propriety of, the requested relief was influenced by an erroneous view of the Commission's authority. In addition, the district court's recognition of the defendants' post-trial submission of written procedures unfairly denied the Commission an opportunity to test the adequacy and relevance of those procedures at trial.

The foregoing errors prevented the district court from properly exercising its discretion on the Commission's request for an injunction and other equitable relief, and provide separate and distinct bases necessitating remand of this case to the lower court for reconsideration.

* * *

The federal securities laws were designed to improve the lot of public investors and to insure fair dealing in the securities markets. Congress gave to the Commission the primary role of assuring such fairness and the prevention of injury to investors. This Court noted many years ago: "The essential object of securities legislation is to protect those who do not know market conditions from the overreachings of those who do." Charles Hughes & Co. v. Securities and Exchange Commission, 139 F.2d 434, 437 (C.A. 2, 1943), certiorari denied, 321 U.S. 786 (1944). If the kind of conduct engaged in here by Mr. Schuman, irrespective of his motive, which conduct is so injurious to the fairness and integrity of the securities trading markets, is not prohibited by the courts upon application by the Commission, then, to quote again from the Charles Hughes case, "we should leave such legislation little more than a snare and a delusion." Id. at 438.

CONCLUSION

For the foreging reasons, the judgment of the district court which dismissed the Commission's action should be reversed, and the case remanded to the district court with instructions to consider, under proper legal standards, whether, in the exercise of its informed discretion, to issue an injunction and to direct the formulation and implementation of written procedures. Alternatively, this Court should, on the basis of the record made below, direct the district court to grant the relief requested by the Commission.

Respectfully submitted,

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

April 4, 1977

A. Daniel Fusaro, Esquire
Clerk, United States Court of
Appeals for the Second Circuit
United States Courthouse
Foley Square
New York, New York 10007

Re: Securities and Exchange Commission v. Bausch & Lomb Incorporated and Daniel G. Schuman, No. 76-6189

Dear Mr. Fusaro:

Enclosed for filing are ten copies of the final printed version of the brief of appellant Securities and Exchange Commission in the above-captioned case. These are submitted in substitution for the page-proof copies of the brief which were filed with the Court and served on all parties by mail on Friday, April 1, 1977. I have also enclosed for your convenience a copy of the Commission's Motion for Leave to File Brief Exceeding 70 Pages, the original and three copies of which were filed together with our page proof brief on April 1, 1977.

I certify that I have caused copies of the foregoing printed brief to be mailed to counsel for appellees as follows:

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Sincerely,

Kathryn B. McGrath

Kathryn B. McGrath
Assistant General Counsel

Enclosures